



INSPIRING YOUR PRODUCTS AND MANUFACTURING
annual report and accounts 2005

OUR STRATEGY

Our goal is to be a leader in the optical fibre-based laser market.

OUR HISTORY

SPI's current business was established in 2000 to exploit technology developed by the renowned Optoelectronics Research Centre at the University of Southampton. Initially, SPI focused on the manufacture of optical components for the long-distance, high-speed telecommunications industry. In doing so, SPI gained expertise in the design and manufacture of specialty optical fibre and Bragg gratings, a form of mirror or filter contained in optical fibre, for use in optical processing. These skills are transportable into other markets.

In 2003, the Company re-launched as a fibre supplier and developed its first portfolio for the industrial laser market place during 2004.

QUARTER 1

- Industrial interfaces added to first MICRO laser combined with regulatory compliance
- First lasers sold into production stent environment
- Capital injection of £1.6m net from venture investors

QUARTER 2

- Released product roadmap for MICRO and MARKING at Laser 2005
- Cell-based manufacturing introduced
- Capital injection of £2.2m net from venture investors
- Venture finance loan received of £2.0m

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AT A GLANCE

SPI is now a recognised leader in the design and manufacture of fibre lasers. The Company's technology is rapidly becoming an integral part of producing many end-user products by improving, and in some cases enabling, its customers' manufacturing processes. **SPI** continues to expand the applications space for fibre lasers, with powers from mWs to kW.

QUARTER 3

- Annual review confirms continued ISO9001
- Group sales for year to date exceed total sales in 2004
- SPI Lasers plc and Group structure established
- Graham Meek joins the Board as non-executive chairman

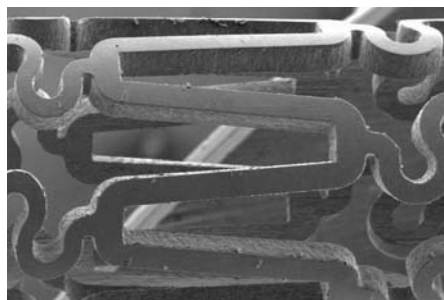
QUARTER 4

- Floated on AIM raising £10.5m net
- Two supply agreements signed for pulsed MARKING laser
- Fibre platform proven to scale in power to encompass majority of MICRO market
- Customers use SPI product for demanding new stent material (nitinol)
- Opened up ten market verticals and applications with increasing numbers of repeat purchases
- Peter Schultz joins the Board as non-executive director



MARKING

The production of equipment to produce permanent marking on a wide range of products. Examples include consumer, electronics, semi-conductor, automotive and aerospace.



MICRO

A term for a diverse set of applications that require fine or precise cutting or welding. These include medical components (e.g. stents), electronic assembly, printing etc.



MACRO

Cutting and welding of larger parts in industries such as automotive, white goods, etc.

OUR TECHNOLOGY

The fibre laser requires the same basic elements as any other laser systems. In the case of the fibre laser, all of the elements are contained within the optical fibre, thus leading to an integrated solution which avoids the need for complex precision assemblies found in conventional lasers. The flexible nature of the optical fibre allows for a compact format which is significantly smaller than its industrial counterparts. The properties of the optical fibre lead to superior performance in many parameters.

The entire laser unit is contained in a standard, 19 inch rack or compact OEM unit. One product can serve many markets and they are software configurable. **SPI** Lasers enjoys a wide range of intellectual property and know-how, most notably our GTWave™ technology, which allows robust and simple assembly without the use of complex or expensive sub-components. This is deployed as a standard technology platform throughout the product set.

CURRENT PRODUCTS



50-100W AIR COOLED

This laser is used in the MICRO market for fine feature cutting. The air cooling aids installation where machine mobility is required.



2-20W CW & PULSED

This product has been designed to meet the needs of the MARKING market. It operates at high speed which translates into faster throughput for end-users.



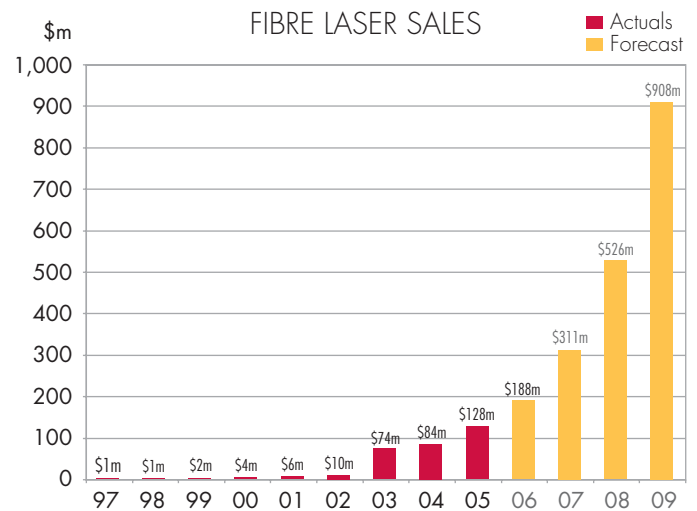
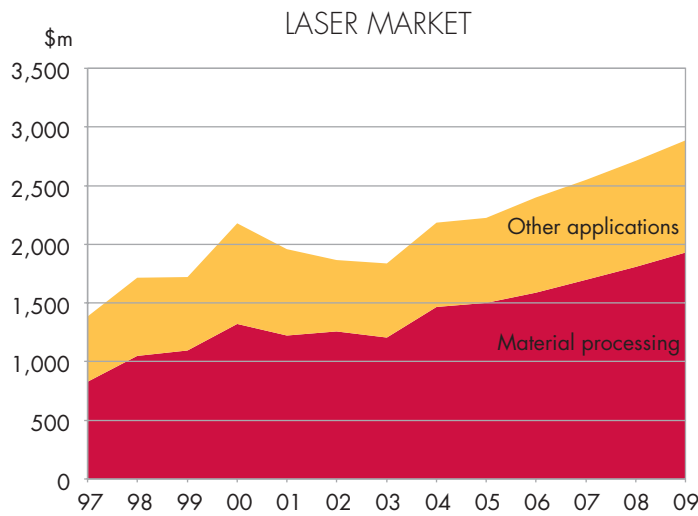
50-200W WATER COOLED

Our water cooler product is designed to offer industry leading stability, hence increasing cut and weld quality for end-users in its MICRO market.

OUR MARKETS

SPI lasers participate in the \$2.0 billion annual global market for laser sources. The market is set to grow strongly over the next three years. The majority of our business falls into the overall category of industrial materials processing.

Within this market, the fibre laser is set to continue as the fastest growing sub-segment.



Source: fibre laser market penetration per LaserFocusWorld Lasers & Photonics Marketplace Seminar 2006

The rapid growth of fibre laser sales is due to the widely recognised advantages offered by the product:

PERFORMANCE

Small, highly intense output beams with industry leading stability

SIZE

Compact and easy to integrate

EFFICIENCY

Significant improvements in efficiency compared to conventional lasers

MAINTENANCE

Little or no replacement parts or post-installation maintenance

CHAIRMAN'S STATEMENT



"SPI LASERS IS A YOUNG COMPANY. IN 2005, WE DEMONSTRATED THAT WE COULD ACHIEVE TRACTION IN THE RAPIDLY GROWING FIBRE LASER ARENA. THE EXCITING CHALLENGE FOR 2006 AND BEYOND IS TO SUSTAIN THAT MOMENTUM WITH A BROADER RANGE OF PRODUCTS AND ACROSS A WIDER RANGE OF APPLICATIONS."

INTRODUCTION

I am pleased to present my first report as Chairman of SPI Lasers plc for the year ended 31 December 2005. The Company achieved a successful flotation on the AIM market on 26 October 2005, raising £10.5 million net of expenses to help finance the Company's development. Significantly, all the private equity investors who financed the early years of SPI have retained their investment, and have been joined by a broad spread of institutional and individual shareholders.

The flotation has also marked the end of the transitional period for the business in which it refocused away from communications towards the fast growing fibre laser arena. Having released its first products and achieved sales, the Company is using the capital raised to expand its product portfolio and channels to market.

PERFORMANCE DURING 2005

The Company achieved a number of significant milestones during 2005. Turnover doubled over the previous year's outcome, with both product sales and contract revenues growing strongly. The Company currently derives a considerable amount, though minor proportion, of its revenues from contract development

SUMMARY

- SUCCESSFUL FLOTATION
- TURNOVER DOUBLES
- STRONG GROWTH IN PRODUCT SALES
- BOARD ESTABLISHED AND FUNCTIONING

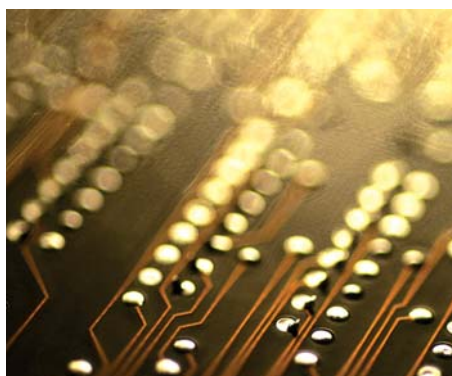
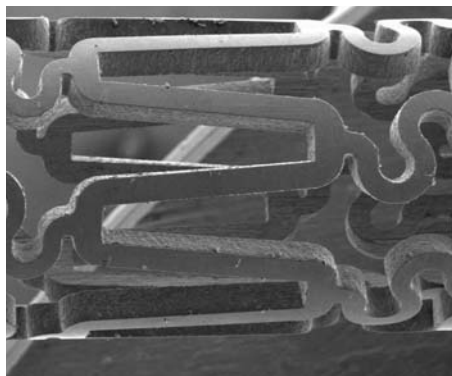
and bespoke products, though this proportion will decline as the range and market penetration of SPI's standard products grow. Customer evaluations of SPI products increased, over thirty accounts were opened and increasingly our revenues are being generated from repeat business from established purchasers.

THE BOARD

During the second half of 2005 we have established a Board appropriate for the needs of an AIM listed company. Amongst the non-executive directors, there is a blend of continuity and new faces. Dave Cheesman and Dave Shrigley have been joined by Dr Peter Schultz and me as Chairman. The Board is developing quickly into an effective team, responding well to the challenges demanded of a quoted company. A good start has been made in addressing the issues arising in today's Corporate Governance environment. Further progress will be made in this area in 2006.

EMPLOYEES

On behalf of the Board I would like to thank all our employees for their contribution and support during the past year. My thanks also go to my fellow Board members and the senior management for all their efforts.



CUTTING

With a strong ethos of product innovation, technology leadership and customer focus, SPI Lasers is enabling the resolution of some of today's most challenging and commercially sensitive manufacturing issues.

Where existing technology has previously limited the precision cutting of miniature parts, the fibre laser has enabled manufacturers to produce ground breaking microscopic cut detail in some of the world's smallest coronary stents.

The highly competitive electronics sector continues to leverage the enormous benefits of SPI's technology, for example, superior cut quality of solder mask stencils for circuit boards.

STRATEGY

The overall strategy for the Company has developed further during the year. In the near term we will continue to broaden our addressed sectors in the MICRO market aided by the introduction of the 200W laser and the release of our first product for the fast growing laser MARKING market. In the medium term we continue to investigate entry strategies into the MACRO market.

SPI Lasers is a young company. In 2005 we demonstrated that we could achieve traction in the rapidly growing fibre laser arena. The exciting challenge for 2006 and beyond is to sustain that momentum with a broader range of products and across a wider range of applications.

GRAHAM MEEK
NON-EXECUTIVE CHAIRMAN
23 MARCH 2006

CHIEF EXECUTIVE'S REVIEW



"2005 WAS A YEAR OF SIGNIFICANT PROGRESS IN ALL ASPECTS OF OUR BUSINESS. WE COMPLETED OUR TRANSITION INTO BECOMING A MANUFACTURER OF FIBRE LASER SOURCES, RELEASED THE FIRST WAVE OF PRODUCTS FOR INDUSTRIAL MATERIAL PROCESSING AND ENGAGED WITH A DIVERSE CUSTOMER BASE."

SUMMARY

- SOLID MAIDEN RESULTS EXCEEDING MARKET EXPECTATIONS FOR TOP LINE GROWTH
- INCREASED SALES IN MICRO
- EXPANDED GLOBAL REACH AND MARKET VERTICALS
- SET THE SCENE FOR GROWTH IN 2006

INTRODUCTION

I am pleased to report that 2005 was a year of significant progress in all aspects of our business. In summary, we completed our transition into becoming a manufacturer of fibre laser sources, released the first wave of products for industrial material processing and engaged with a diverse customer base. This has led to a solid set of maiden operating results; a key element of which is our top line growth of 100%. It is significant that in this regard we exceeded market expectations, but more importantly, we created momentum in the sales channel that bodes well for sustained growth in 2006 and beyond.

There are a number of areas I would highlight as particularly significant:

MARKETS, CUSTOMERS AND CHANNEL

The laser industry is a large and established market. During 2005 the fibre laser became recognised not only as an interesting technology, but as a tool that delivers real advantages for many end-users. I believe that SPI Lasers joining the market as the second supplier to IPG Photonics of industrial grade products has been a factor in this maturing process.

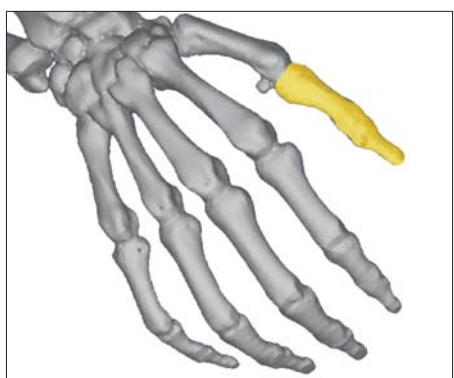
SPI's customers are system integrators. That is to say that they build the end-user system that incorporates our lasers as the optical source. In some cases these integrators are part of the end-user entity, but in the majority of cases they are an intermediary. Consequently we have invested heavily in creating awareness of the many advantages of fibre lasers in the end-user community to create "pull through" in the sales channel. I am pleased to report that this approach is proving to be successful.

In 2005 we concentrated on the MICRO sector. Of note within this was the progress we made in penetrating the medical device manufacturing market, where the fibre laser's ability to cut and weld fine feature size items rapidly and with high quality has been a differentiator. Initial success was in cutting stents (a stent is a spring-like structure expanded within veins and arteries) with a number of industry leaders now deploying SPI product. Having established ourselves in this sub-sector we are now engaged with a number of other customers and working on new applications.

This is typical of our approach to the market: namely to excel at an application and then to drive penetration. In parallel with this success, we have succeeded in adding further market verticals such as stencil cutting, printing and micro welding. To support this, we have added to our channel resource, both direct and through specialist distribution partners, and established an applications and support capability in the UK and the USA.

Towards the end of 2005, we announced a family of products designed for the rapidly growing MARKING sector. Two supply contracts were signed and a number of customer relationships established that should lead to sales in 2006.

All of this activity is consistent with our strategy of utilising our specialised optical fibre capability to establish a technology platform that can be sold into multiple markets. We continue to strive for products that deliver the advantages in performance and cost of ownership that industry watchers believe will fuel rapid growth in this sector.



MATERIALS PROCESSING

SPI fibre laser technology has also made a significant impact in material processing. Pushing beyond the limits of traditional manufacturing, fibre laser technology from SPI has enabled advances in techniques used in the production of many end-user products.

SPI technology has facilitated major productivity advances in manufacturing processes that require small spot welding, sintering and even the production of complex shapes using the emerging process of 3D rapid prototyping.

OPERATIONAL

Evidence of the emphasis on the operational functions of the business in 2005 was the development and manufacturing transfer of our initial product set. We successfully introduced a range of products from 10W to 150W, consistent with the needs of the MICRO sector. This, along with execution of our awarded contracts, was pivotal in achieving our revenue objectives for the year.

In parallel with this, we achieved significant progress in the design of a novel pulsed laser for the MARKING sector which is designed to operate faster than the competitive offering.

As evidenced by the signing of the two significant supply contracts and the acquisition of several other customers, our pulsed product has generated a larger amount of business than we anticipated for a pre-release product. Whilst this is clearly positive for the future, it will result in SPI needing to accelerate manufacture of the product faster than our planned cost reduction activity, with an associated shorter term pressure on gross margins. This is primarily due to the cost of some bought in components and will be resolved by working with our suppliers during 2006. We consider this to be a justifiable investment that should result in greater market share than originally foreseen over the medium term.

Progress was also made in scaling the power of our technology platform to address other areas of MICRO and future MACRO products. In the latter case the results obtained have been so encouraging that we will increase investment in this area in 2006 to position the Company to enter this large market sector in 2007.

As regards organisational development, we established a manufacturing organisation, and made improvements in our operating business and quality systems. Again, the emphasis here was in preparation for continued strong growth in 2006.

OUTLOOK AND KEY EVENTS

In 2006 we expect to sustain the momentum built last year. We will expand our sales channel, R&D and manufacturing resources to enable us to address multiple new market verticals. The new 200W product will broaden our offering in the MICRO sector. This, combined with the general release of our MARKING laser, will more than double the available market for SPI Lasers. We also expect that by leveraging our contract R&D and through organic investment we will make significant strides towards the commercialisation of our technology in MACRO. These initiatives, along with investment in physical infrastructure, are occurring earlier and at a faster pace than we would have anticipated last year. We believe that they are essential to prepare the Company for the forecast growth in this sector which has also increased.

The exciting challenge for 2006 and beyond is therefore to deliver on the increasing number of opportunities by developing new products and accelerating those already introduced to take advantage of this expanding market.

DAVID PARKER
CHIEF EXECUTIVE OFFICER
23 MARCH 2006



“2005 WAS A YEAR OF CHANGE FOR THE SPI GROUP, STRUCTURALLY, COMMERCIALY AND OPERATIONALLY. COMMERCIALY, WE SAW VERY STRONG GROWTH IN THE COMPANY’S SALES OF FIBRE LASER PRODUCTS IN ALL OF OUR GEOGRAPHIC MARKETS.”

OVERVIEW

2005 was a year of change for the SPI Group, structurally, commercially and operationally. We started the year as a Delaware registered private company, Southampton Photonics, Inc. and ended the year as a UK public company, SPI Lasers plc. Commercially, we saw very strong growth in the Company’s sales of fibre laser products in all of our geographic markets. Our investment in manufacturing expansion, product development and particularly in sales and marketing were all important factors in achieving strong top-line growth and led to an increased need for working capital. This financing need lies behind the decision to take the Company public, thereby raising the necessary funds to drive the Company forward so as to better address the opportunities for success open to us.

STRUCTURAL CHANGES

The Company started the year as Southampton Photonics, Inc., a Delaware registered company with Southampton Photonics Ltd as its 100% owned UK subsidiary. Through a process of Group restructuring SPI Lasers plc, a newly incorporated company, became the parent of the Group with two subsidiaries: SPI Lasers UK Ltd and SPI Lasers LLC.

SUMMARY

- GROUP RESTRUCTURING COMPLETED
- SALES GREW BY 100% TO £3.5 MILLION
- INVESTMENT IN R&D INCREASED BY 24%
- IPO RAISED £10.5 MILLION (NET)
- BALANCE SHEET STRENGTHENED

In order to provide meaningful information to shareholders, this restructuring is reflected in the accounts of the Company, as a merger in accordance with the requirements of FRS 6 regarding Group restructures. Accordingly the prior year comparatives have been presented as if the Group had existed in its present form during that period.

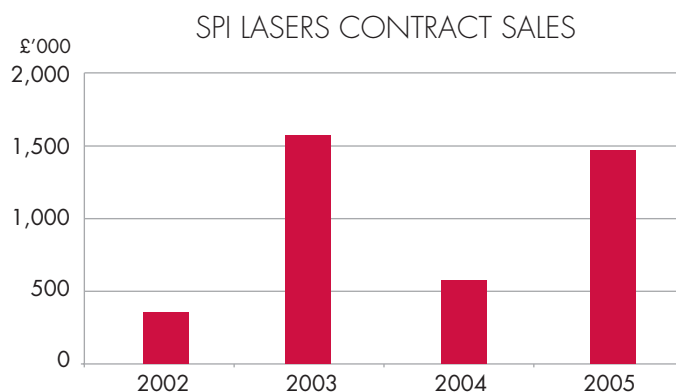
COMMERCIAL CHANGES

Sales

Total sales grew by 100% over 2004 to £3.5 million with an underlying product sales growth of 58%. Product sales have grown from £0.2 million in 2002 to £2.0 million in 2005.

Contract sales, which relate to our US and UK defence and aerospace development contracts, grew by over 200% in the year, building on an initial US contract award in 2002 that generated revenues from late 2002 through to early 2004.

The USA remains our biggest market with £2.1 million of total sales, an increase of 79% on the prior year’s sales of £1.2 million. However, SPI’s dependency upon sales to the US has continued to reduce: 60% of sales in 2005, down from 67% in 2004, as other market areas were further expanded: Asia up from 7% to 10% and Europe (excluding the UK) up from 6% to 17%.



The balance of sales was in the UK, which while increasing in absolute terms by almost a third, reduced in proportional terms from 20% to 13% of the total.

OPERATIONAL CHANGES

Gross loss

The gross loss of £1.4 million was 59% lower than in 2004; a 43% reduction ignoring the prior year's exceptional impairment charge. This reduction in the gross loss is a reflection of the improving cost structure of the business, whereby SPI has been able to leverage off its predominantly fixed-cost manufacturing base as volumes have increased. This trend will continue as volumes continue to grow.

Administrative expenses

Administrative expenses include £3.0 million of Company funded product research and development (R&D). In addition, and charged against cost of sales, SPI spent £1.1 million on customer funded R&D. The total incurred investment in R&D was therefore £4.1 million, 117% of 2005 sales, which compares with £3.3 million in 2004. The balance of the administrative expenses relates to sales and marketing and general administration costs. Administrative expenses before exceptional costs in total were

£1.6 million higher than in 2004, an increase of 28%. This reflects, in the main, the increased investment in sales and marketing that was necessary to achieve the growth in sales.

The exceptional items charge of £0.3 million relates to costs associated with the flotation of the Company that are not chargeable to the share premium account.

Taxation

SPI has an unrecognised potential deferred tax asset of £10.0 million, which has primarily arisen from the losses incurred to date. In 2005, an R&D tax credit of £0.5 million (£0.5 million in 2004) was recognised; the associated cash payment from HM Revenues & Customs is expected to be received in the second half of 2006 (the 2004 related tax credit was received in September 2005).

Loss after taxation

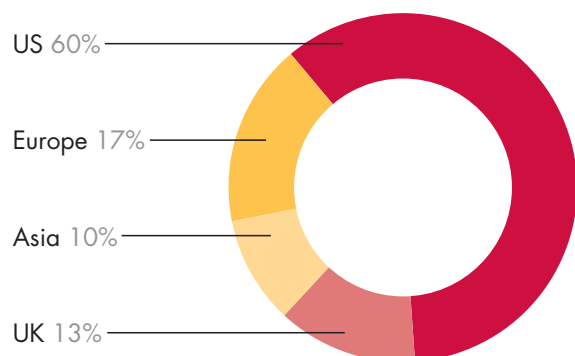
The loss after taxation for 2005 was £8.4 million (2004 £8.5 million). Before exceptional charges, the loss increased by £0.6 million (9%) over the equivalent loss in 2004. This is due to the ramp-up of resources within operations and sales and marketing.

Dividend

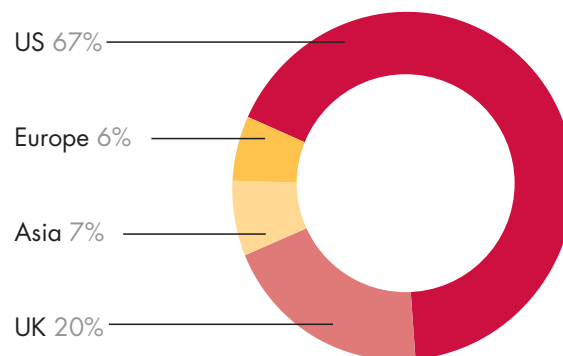
The directors do not propose to pay a dividend (2004: nil).

FINANCIAL REVIEW

2005 SALES



2004 SALES



OPERATIONAL CHANGES (CONTINUED)

Headcount

Average headcount increased from 73 in 2004 to 88 in 2005. Sales increased from £24,000 per head in 2004 to £39,000 per head in 2005 and the loss after tax for 2004 and 2005 reduced from £116,000 per head to £96,000 per head respectively.

Fixed assets

Gross fixed assets grew by £0.5 million during 2005, an increase of 4% on the balance as at 31 December 2004. This comparatively low level is a reflection of the significant investment in fixed assets in earlier years, particularly pre-2004, which created the inherent capability to produce fibre lasers in volume. SPI's investment in fixed assets is now mostly related to some further increase in capacity rather than the underlying capability.

Depreciation for 2005 was £0.5 million (2004: £1.2 million). The reduction in the charge from the 2004 level is primarily due to the exceptional asset impairment that took place as at 31 December 2004, which, as a result, has reduced the ongoing annual depreciation charge. Depreciation at 31 December 2005 stands at 81% of the gross cost of the assets.

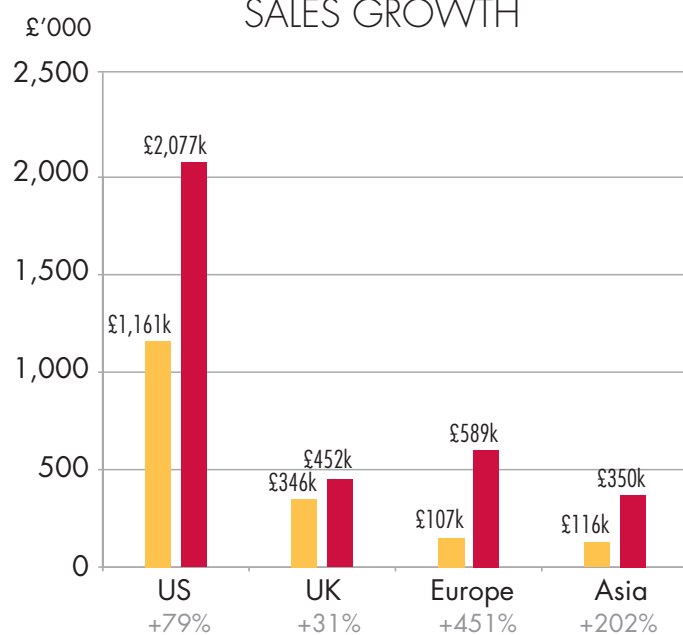
Working capital

Net current assets, excluding cash and short term investments (working capital), increased from £0.5 million at 31 December 2004 to £1.7 million at 31 December 2005. Stocks increased by £1.5 million and debtors by £1.4 million, offset by an increase in creditors of £1.7 million. The net increase in working capital of £1.2 million was primarily as a result of the strong sales volume growth experienced by SPI during 2005. Actions are already in place to improve our business processes and systems during 2006 that will improve our logistics efficiency and so help increase the working capital turns.

Loans

A venture loan was provided in June 2005 by ETV Capital SA (Luxembourg) to provide working capital for the Company in advance of it being able to access finance from the IPO in October 2005. The loan is secured on the fixed assets of the Company and is repayable over 36 months at an interest rate of 12.65% per annum.

SALES GROWTH



Equity raised

Pre-IPO: the Group received £3.8 million of equity investment from its existing Venture Capital investors during the first half of 2005.

AIM listing: the listing on AIM in October 2005 raised £12.0 million gross. This, after transaction costs of £1.5 million was reduced to a net injection of £10.5 million into the Company. Of these costs, £1.2 million were direct costs of the share issue and have been set off against the share premium account; the remaining costs are shown as exceptional costs within the profit and loss account. The cash balance at 31 December 2005 was £8.1 million, in line with expectations.

STEVE BERG

CHIEF FINANCIAL OFFICER

23 MARCH 2006

BOARD OF DIRECTORS



GRAHAM MEEK *¹ §¹

NON-EXECUTIVE CHAIRMAN

Graham Meek, age 58, joined the Group in 2005. He is currently chairman of ICM Computer Group plc (having served as senior independent director from 2002-2004), a non-executive director of Filtronic plc and a non-executive director of Capital Gearing Trust plc. He has had a long career in investment banking and stockbroking, with particular experience of the information technology and telecommunications sectors. Graham was previously head of corporate finance at Beeson Gregory plc, a managing director of Merrill Lynch Capital Markets and an executive director of Smith New Court plc.



DAVID PARKER

PRESIDENT AND CHIEF EXECUTIVE OFFICER

David Parker, age 43, joined the Group in 2002 and has been the chief executive officer since this time. He is the former president and chief executive officer of Marconi Optical Components ("MOC"). Under his leadership, MOC was sold to Bookham Technology in February 2002. Prior to this, he was vice president general manager of Agilent Technologies' Ipswich components operation and a corporate vice president of Agilent. During his tenure, this business unit became the market leader in the supply of high performance networking components. In previous roles, he has gained experience in manufacturing, research and development and business development. He serves as a non-executive director on the board of Zinwave, Inc. and was formerly a member of the supervisory board of Xignal Technologies AG. He was elected a Fellow of the Institute of Physics in 1997. David has a PhD from Imperial College, University of London and a BSc from the University of Leeds.



STEVE BERG

CHIEF FINANCIAL OFFICER AND COMPANY SECRETARY

Steve Berg, age 51, has been chief financial officer of the Group since February 2003. Prior to joining the Company, he was the chief financial officer of Marconi Optical Components until it was sold to Bookham Technology in 2002. Steve joined Marconi in 1988, first in the GEC-Marconi defence division before moving to GEC's telecommunications subsidiary, GPT (GEC-Plessey Telecommunications), in 1991 and was appointed GPT's chief financial officer in 1997. He moved to Marconi Capital in 1999 as a director of corporate finance, where he was involved in various investment activities in North America, Europe, the Middle East and Asia. Prior to joining GEC, He gained further experience with NORTEL and Invensys. Steve is a Chartered Management Accountant (Fellow) with a postgraduate diploma in management from Coventry University.



DAVID PAYNE *

PART TIME EXECUTIVE DIRECTOR

David Payne, age 61, co-founded SPI Inc in 1997. He heads the Optoelectronics Research Centre at the University of Southampton (ORC), a facility containing over 60 research laboratories and more than 150 full time researchers. He led the team that invented the erbium-doped fibre amplifier, the enabling technology for dense wavelength division, multiplexing and the growth of the Internet. In 1998, the Franklin Institute recognised this achievement and awarded David Payne with its prestigious Benjamin Franklin Medal for the invention. David is a Fellow of the Royal Society and the Royal Academy of Engineering and was awarded the CBE in 2004.

*¹ Chairman of Audit Committee

* Member of Audit Committee

§¹ Chairman of Remuneration Committee

§ Remuneration Committee

*¹ Chairman of Nominations Committee

*¹ Nominations Committee



PETER SCHULTZ * §1 ¥

NON-EXECUTIVE DIRECTOR

Peter Schultz, age 63, joined the Group in 2005. He is retired president of Heraeus Tenevo Inc., a technical glass manufacturer specialising in fibre optics and semi-conductor markets, and chief technical officer North America for Heraeus Holding GmbH. Following graduation from Rutgers University (BSc 1964, PhD 1967), he co-developed the world's first practical glass optical fibre for communications in 1970 as a scientist at Corning, Inc. He is co-inventor of the fibre optics now used worldwide for telecommunications. In 1993, he was inducted into the National Inventors Hall of Fame and in 2000 received the National Medal of Technology from President Clinton for this accomplishment. Peter is the recipient of numerous awards, including the International Glass Science Award (1977), SPIE Technology Achievement Award (1981), ASM Engineering Materials Achievement Award (1983) and the First American Innovators Award (US Department of Commerce 1995).



DAVID CHEESMAN*

NON-EXECUTIVE DIRECTOR

David Cheesman, age 63, joined the Group in 2003. He worked in the computer industry for over twenty years, becoming chief engineer at Computer and Systems Engineering Limited and Univac's director of technical operations for Europe. In 1978, he set up Prime Computer Inc's research and development operations in the UK, before becoming managing director of Dowty Information Systems Limited. In 1988, he left industry to join the venture capital community, becoming a Director of 3i's high-tech unit. Subsequently, he was a founding partner in TriTech Investment Managers and, in 1997, became a partner at Advent Venture Partners, specialising in IT investment. David has invested in over 40 high-tech companies and been active on the boards of 32 of these. He has an Honours degree in Electrical Engineering and is a Chartered Engineer and a Fellow of the Institute of Electrical Engineers.



DAVID SHRIGLEY §

NON-EXECUTIVE DIRECTOR

David Shrigley, age 57, joined the Group in 2000. He was a Sevin Rosen Funds general partner from 1999 until November 2005. Prior to joining Sevin Rosen Funds he worked at Bay Networks as executive vice president responsible for marketing, sales and service. Prior to Bay Networks, he spent 18 years at Intel. From 1989 to 1995 he was vice president and general manager for Intel's Asia-Pacific region and from 1995 to 1996 co-managed the company's entire corporate marketing operation. David sits on the boards of Everypath Inc., UltraCell Corporation and nTag Interactive Corporation. David Shrigley holds a BSc degree in Business Administration from Franklin University.



FREDERICK LEONBERGER

TECHNICAL ADVISOR / SPECIAL ADVISOR TO THE BOARD

Dr Leonberger joined the Group as a technical adviser in 2005. Frederick served as senior vice president and chief technology officer of JDS Uniphase Corporation, a leading optical components supplier from 1999 until his retirement in June 2003. He previously held a similar position at Uniphase Corporation prior to its merger with JDS Fitel in 1999. He joined Uniphase in 1995 upon its acquisition of UTP, a company he co-founded and served as general manager. He has been active in photonics for over 25 years and has also held a variety of staff and management positions at MIT Lincoln Laboratory and United Technologies Research Center. He is presently the principal of EOvation Technologies LLC, a technology advisory firm he founded in July 2003. He serves on the board of directors of RF MicroDevices, Agility Communications and Aliphion, and is a member of the National Academy of Engineering.

DIRECTORS' REPORT

The directors present their annual report and audited Group financial statements for the year ended 31 December 2005.

PRINCIPAL ACTIVITIES AND BUSINESS REVIEW

The Group is a leader in the design, development, engineering and manufacture of optical fibre-based laser sources for a range of markets and applications. The Company's products are based on the innovative and proprietary fibre technology platform which enables high performance together with a substantial reduction in the size of the product and the total cost to the end-user compared to more traditional lasers.

Further details of the Group's performance during the year and expected future developments are contained in the chairman's statement and the financial review.

BASIS OF PREPARATION

The Company was incorporated on 25 August 2005 under the name of Wilmerhale 1 plc and changed its name to SPI Lasers plc on 30 August 2005. On 26 October 2005, the Company was registered as a public limited company.

Although there is no statutory requirement to prepare audited financial accounts for the Company until the period ended 31 December 2006, the directors believe that it is in the shareholders' interests that audited consolidated accounts are prepared for the period ended 31 December 2005.

As part of the process to enable a placing with institutional investors of ordinary shares on the Alternative Investment Market ('AIM'), the Group underwent a restructuring. This has been accounted for using merger accounting principles, whereby following the creation of SPI Lasers plc and SPI Lasers LLC, SPI Lasers LLC merged with Southampton Photonics, Inc. For the consolidated accounts, the adoption of merger accounting presents SPI Lasers plc as if it always had been the parent undertaking of the Group. Consequently the consolidated accounts include a profit and loss covering the year to 31 December 2005 with comparative figures for the prior year, both of which have been prepared as if SPI Lasers plc had been the parent undertaking throughout that period. Equally, Group balance sheets and statements of cash flows have been included to complement the profit and loss accounts.

RESULTS AND DIVIDENDS

The loss for the financial year of £8,436,000 (2004: loss £8,482,000) has been taken to the reserves.

The directors do not recommend the payment of a dividend (2004: £nil).

CORPORATE GOVERNANCE

Introduction

SPI Lasers plc was listed on AIM on 26 October 2005. Although the AIM Rules do not require the Group to comply with the Combined Code on Corporate Governance ('the Code'), the Group supports the principles set out in the Code and will attempt to comply wherever possible, given both the size and resources available to the Group. Details are provided below of how the Group applies the Code.

The Board

The Board of directors comprises three executive directors (one of whom is part-time), and four non-executive directors, one of whom is the Chairman.

The Board meets each month and receives a Board pack comprising reports from each of the executive directors together with any other material deemed necessary for the Board to discharge its duties. It is the Board's responsibility for formulating, reviewing and approving the Group's strategy, budgets, major items of expenditure and acquisitions.

Board Committees

The Board has established three committees: the Audit Committee, the Remuneration Committee and the Nominations Committee, each of which has written terms of delegated responsibilities.

Audit Committee

The Audit Committee, chaired by Graham Meek, comprises three non-executive directors and is scheduled to meet three times a year with the Chief Executive and the Chief Financial Officer in attendance. It is the Audit Committee's role to provide formal and transparent arrangements for considering how to apply the financial reporting and internal control requirements of the Code, whilst maintaining an appropriate relationship with the independent auditors of the Group. The Audit Committee assists the Board in the discharge of its duties concerning the announcements of results, the Annual Report and Accounts and the maintenance of proper internal controls. It reviews the scope and planning of the audit and the auditor's findings and considers Group accounting policies and the compliance of those policies with applicable legal and accounting standards. The Audit Committee meets at least twice a year with the auditors without the executive directors being present.

Remuneration Committee

The Remuneration Committee, chaired by Peter Schultz, comprises three non-executive directors and meets at least twice a year. It is the Remuneration Committee's role to establish a formal and transparent policy on executive remuneration and to set remuneration packages for individual executive directors, within agreed terms of reference. No director may participate in discussions relating to their own terms and conditions of service or remuneration.

Nominations Committee

The Nominations Committee, chaired by Graham Meek, comprises three non-executive directors, and meets at least twice a year to consider the size, structure and composition of the Board, to formulate and review proposals for the appointment and retirement of directors and make recommendations thereon to the Board.

Internal control and risk management

The Board is responsible for the system of internal control and for reviewing its effectiveness. The Group maintains a system of internal control consistent with a Group at its stage of development and as it grows, the Board intends to continue to enhance its processes to identify risks facing the business and implement procedures to eliminate, mitigate and monitor those risks.

The Group does not currently have an internal audit function due to the small size of the administrative function and the high level of director review and authorisation of transactions.

A comprehensive budgeting process is completed once a year and is reviewed and approved by the Board. The Group's results, as compared against budget, are reported to the Board on a monthly basis and discussed in detail at each meeting of the Board.

The Group maintains appropriate insurance cover in respect of legal actions against the directors as well as against material loss or claims against the Group and reviews the adequacy of the cover regularly.

Rotation of directors

At the first Annual General Meeting, all directors will retire and will then be eligible for reappointment. In subsequent years, one third of the directors who are subject to retirement by rotation shall retire from office. Initially, a few directors may be put forward for re-election earlier than three years so that a smooth process results.

A statement of the directors' responsibilities in respect of the financial statements is set out on page 18.

RESEARCH AND DEVELOPMENT

During the year the Group spent £2,962,000 (2004: £2,929,000) on research and development, representing 85% of turnover (2004: 169%). It is anticipated that the Group will continue to increase research and development expenditure in order to accelerate the development of the product portfolio.

DIRECTORS AND THEIR INTERESTS

The directors in office during the year, their interests in shares in the Company and their emoluments were as follows:

	Ordinary shares		Total emoluments 2005 £000
	31 December 2005 Number	25 August 2005 (or date of appointment if later) Number	
D Payne	169,844	162,900	33
D Parker	322,682	315,738	288
S Berg	3,472	—	187
G Meek	34,722	—	6
P Schultz	9,792	—	15
D Cheesman	—	—	—
D Shrigley	—	—	—

There have been no changes to shareholdings between the end of the financial year and the date of this report.

DIRECTORS' REPORT

DIRECTORS AND THEIR INTERESTS (CONTINUED)

At the year end and the date of this report, the directors had the following share options:

	At 25 August 2005	Granted	Exercised	At 31 December 2005	Exercise price	Date from which exercisable	Expiry date
D Parker*	—	675	—	675	£122.37	April 2003	September 2012
D Parker**	—	299	—	299	£122.37	April 2003	September 2012
D Parker**	—	148,599	—	148,599	£0.07	September 2005	September 2012
S Berg*	—	180	—	180	£181.28	February 2004	March 2013
S Berg*	—	54,700	—	54,700	£0.03	February 2004	October 2013
S Berg*	—	26,229	—	26,229	£0.05	February 2004	August 2014
S Berg*	—	67,563	—	67,563	£0.07	September 2005	September 2015

* Award granted under EMI scheme

** Award granted under Unapproved scheme

All the share options in the above scheme were granted on 25 October 2005 following the surrender of a proportional number of share options in the share option scheme of the previous ultimate parent undertaking, Southampton Photonics, Inc., which has been closed.

The Group has indemnified the directors of the Company against liability in respect of proceedings brought by third parties subject to the conditions set out in the Companies Act 1985. Such qualifying third party indemnity provision was in force during the year and continues to be in force as at the date of this report. The Group has purchased directors and officers' liability insurance with an indemnity limit of £5.0 million in order to minimise the potential impact of such proceedings.

PRINCIPAL SHAREHOLDERS

The Company is aware of the following shareholders holding interests of 3% or more of the Company's issued ordinary share capital as at 22 March 2006.

	Ordinary 2.5p shares	% of issued share capital
HSBC Global Custody Nominee (UK)	3,787,185	21.34
Sevin Rosen	2,244,749	12.65
Interwest Partners	2,244,749	12.65
Advent Venture Partners	1,803,211	10.16
Amadeus Capital Partners	1,726,729	9.73
Bank of New York (Nominees)	1,401,050	7.89
BNY (OCS) Nominees Ltd	833,275	4.69
Mellon Nominees (UK) Ltd	658,000	3.71

CHARITABLE CONTRIBUTIONS

During the year, the Company made various charitable contributions totalling £300 (2004: £100).

There were no political donations.

EMPLOYEE INVOLVEMENT

Details of the number of employees and related costs can be found in note 5 to the financial statements on page 27.

The Group is proactive in providing employees with information about the Group.

It operates equal opportunities in recruitment, training and promotion regardless of gender, ethnic origin, nationality, disability or sexual orientation.

ENVIRONMENT

The Group recognises the importance of its environmental responsibilities, monitors its impact on the environment, and designs and implements policies to reduce any damage that might be caused by the Group's activities.

CREDITOR PAYMENT POLICY AND PRACTICE

It is the Company's policy to abide by the payment terms agreed between the Group and its suppliers whenever it is satisfied that the supplier has provided goods and services in accordance with agreed terms and conditions. At 31 December 2005, the Group had 35 days purchases outstanding in trade creditors (2004: 35 days).

FINANCIAL RISK MANAGEMENT OBJECTIVES

Details of the Group's financial risk management objectives are discussed in the financial review. The Group does not hedge forecast transactions.

AUDITORS

Deloitte & Touche LLP were appointed as first auditors of the Company. Deloitte & Touche LLP have indicated that they are willing to continue in office and a resolution proposing their reappointment will be put to the shareholders at the Annual General Meeting.

STEVE BERG

COMPANY SECRETARY

23 MARCH 2006

STATEMENT OF DIRECTORS' RESPONSIBILITIES in respect of the financial statements

United Kingdom company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and of the Group and of the profit or loss of the Group for that period. In preparing those financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

INDEPENDENT AUDITORS' REPORT to the members of SPI Lasers plc

We have audited the Group and individual Company financial statements (the "financial statements") of SPI Lasers plc for the year ended 31 December 2005 which comprise the Group profit and loss account, the Group statement of total recognised gains and losses, the Group and individual Company balance sheets, the Group cash flow statement and the related notes 1 to 26. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the Company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS

The directors' responsibilities for preparing the Annual Report and the Financial Statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the statement of directors' responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant United Kingdom legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view in accordance with the relevant financial reporting framework and are properly prepared in accordance with the Companies Act 1985. We also report to you on the consistency of the directors' report with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the other information contained in the annual report for the above year as described in the contents section and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

BASIS OF AUDIT OPINION

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the circumstances of the Company and the Group, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

OPINION

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Group's and the individual Company's affairs as at 31 December 2005 and of the Group's loss for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the directors' report is consistent with the financial statements.

DELOITTE & TOUCHE LLP

CHARTERED ACCOUNTANTS AND REGISTERED AUDITORS

SOUTHAMPTON, UNITED KINGDOM

23 MARCH 2006

GROUP PROFIT AND LOSS ACCOUNT for the year ended 31 December 2005

	Notes	2005 £000	2004 £000
Turnover	2	3,468	1,730
Cost of sales:			
Excluding exceptional items		(4,872)	(4,179)
Exceptional items	4	—	(1,006)
Total cost of sales		(4,872)	(5,185)
Gross loss		(1,404)	(3,455)
Administrative expenses		(7,354)	(5,750)
Exceptional items	4	(315)	—
Total administrative expenses		(7,669)	(5,750)
Other net operating income		131	161
		(7,538)	(5,589)
Operating loss	3	(8,942)	(9,044)
Interest receivable and similar income		161	85
Interest payable and similar charges	6	(190)	—
Loss on ordinary activities before taxation		(8,971)	(8,959)
Tax credit on loss on ordinary activities	7	535	477
Loss on ordinary activities after taxation		(8,436)	(8,482)
Retained loss for the financial year	21	(8,436)	(8,482)
Loss per ordinary share			
Basic and diluted	9	(47.7)p	(47.9)p

All amounts are derived from continuing activities.

GROUP STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

for the year ended 31 December 2005

	2005 £000	2004 £000
Loss for the financial year	(8,436)	(8,482)
Foreign exchange differences on retranslation of net assets of subsidiary undertakings	25	380
Total recognised gains and losses relating to the year	(8,411)	(8,102)

GROUP BALANCE SHEET at 31 December 2005

	Notes	2005 £000	2004 £000
Fixed assets			
Tangible assets	10	2,424	2,505
Current assets			
Stocks	12	2,084	576
Debtors	13	2,686	1,299
Short term investment		—	256
Cash at bank and in hand		8,126	1,638
		12,896	3,769
Creditors: amounts falling due within one year	14	(3,074)	(1,372)
Net current assets		9,822	2,397
Total assets less current liabilities		12,246	4,902
Creditors: amounts falling due after more than one year	15	(1,039)	—
Provisions for liabilities and charges	18	(165)	(103)
Net assets		11,042	4,799
Capital and reserves			
Called up share capital	20	442	
Share premium account	21	10,605	
Merger reserve	21	50,389	
Profit and loss account	21	(50,394)	
Total equity shareholders' funds		11,042	
Net investment			4,799

GRAHAM MEEK
 CHAIRMAN
 23 MARCH 2006

COMPANY BALANCE SHEET at 31 December 2005

	Notes	2005 £000
Fixed assets		
Investments	11	12,989
Current assets		
Debtors	13	2,894
Cash at bank and in hand		7,221
		10,115
Creditors: amounts falling due within one year	14	(249)
Net current assets		9,866
Total assets less current liabilities		22,855
Creditors: amounts falling due after more than one year	15	(12,192)
Net assets		10,663
Capital and reserves		
Called up share capital	20	442
Share premium account	21	10,605
Profit and loss account	21	(384)
Total equity shareholders' funds		10,663

GRAHAM MEEK
 CHAIRMAN
 23 MARCH 2006

GROUP CASH FLOW STATEMENT for the year ended 31 December 2005

	Notes	2005 £000	2004 £000
Net cash outflow from operating activities	23	(9,997)	(6,818)
Returns on investments and servicing of finance			
Interest received		161	85
Interest paid		(190)	—
Net cash (outflow)/inflow from returns on investments and servicing of finance		(29)	85
Taxation			
UK tax credit received		451	440
Net cash inflow from taxation		451	440
Capital expenditure and financial investment			
Payments to acquire tangible fixed assets		(453)	(251)
Receipts from sales of tangible fixed assets		—	1
Net cash outflow from capital expenditure and financial investment		(453)	(250)
Management of liquid resources			
Decrease/(increase) in current asset investments		256	(127)
Net cash inflow/(outflow) from management of liquid resources		256	(127)
Net cash outflow before financing		(9,772)	(6,670)
Financing			
Issue of share capital		12,003	—
Issue of share capital prior to Group reconstruction		3,841	4,775
Payments of expenses on issue of equity shares		(1,190)	—
New borrowings		2,565	—
Repayment of borrowings		(898)	—
Net cash inflow from financing		16,321	4,775
Increase/(decrease) in cash in period		6,549	(1,895)

NOTES TO THE FINANCIAL STATEMENTS at 31 December 2005

1. ACCOUNTING POLICIES

Basis of preparation

The financial statements are prepared under the historical cost convention and in accordance with applicable United Kingdom Generally Accepted Accounting Practice. The particular accounting policies adopted are described below.

Basis of consolidation

The Group financial statements consolidate the financial statements of SPI Lasers plc and all its subsidiary undertakings drawn up to 31 December each year.

In accordance with Financial Reporting Standards 6 "Acquisitions and Mergers" (FRS 6) the accounts have been prepared using merger accounting and are presented as if the Group had been in existence throughout both the current and prior periods. Consequently the consolidated accounts include a profit and loss covering the year to 31 December 2005 with comparative figures for the prior year, both of which have been prepared as if SPI Lasers plc had existed throughout that period. Equally, Group balance sheets and statements of cash flows have been included to complement the profit and loss accounts.

Further information on the reconstruction is given below.

SPI Lasers plc Group restructuring

SPI Lasers plc was incorporated on 25 August 2005 under the name of Wilmerhale 1 plc and changed its name to SPI Lasers plc on 30 August 2005. On 26 October 2005 its ordinary shares were listed on the Alternative Investment Market.

SPI Lasers plc became the ultimate parent company to SPI Lasers LLC under the 'Merger Agreement' which became effective on 26 October 2005.

Under the terms of the 'Merger Agreement', shares in the Company were offered to existing shareholders of Southampton Photonics, Inc. The details of the 'Merger Agreement' were as follows:

- each share of issued common stock in Southampton Photonics, Inc. of \$0.001 (30,851,938) was exchanged for one ordinary share in SPI Lasers plc of £0.001;
- each share of issued Series A preferred stock in Southampton Photonics, Inc. of \$0.001 (49,448,366) was exchanged for 1.4016 fully paid ordinary shares in SPI Lasers plc of £0.001; and
- each share of issued Series B preferred stock in Southampton Photonics, Inc. (153,769,332) of \$0.001 was exchanged for 0.8709 fully paid ordinary shares in SPI Lasers plc of £0.001.

The ordinary shares in SPI Lasers plc were consolidated on a ratio of 1:25 pre-IPO, reducing the number of ordinary shares in the Company but making no change to the share capital.

The Group reconstruction has been accounted for using merger accounting.

Sale of SPI Lasers UK (as part of the Group reconstruction)

Subsequent to the 'Merger agreement' as outlined above, SPI Lasers LLC sold its 100% shareholding in SPI Lasers UK Ltd to SPI Lasers plc for the principal amount of \$23.0 million, payable on demand as a loan note. This is accounted for in the Company's solus accounts as an acquisition, but has no impact on the consolidated accounts.

Company

The Company balance sheet of SPI Lasers plc is presented at 31 December 2005 only, as this is the first period of accounts of the Company.

No profit and loss account is presented for SPI Lasers plc as permitted by section 230 of the Companies Act 1985.

Turnover

Turnover represents amounts derived from the provision of goods and services which fall within the Company's ordinary activity after deduction of trade discounts and value added tax. The turnover and operating loss is attributable to the principal activity of the Company. Income is recognised on delivery of related goods and services.

Profit is recognised on long term contracts, if the final outcome can be assessed with reasonable certainty, by including in the profit and loss account both turnover and related costs as contract activity progresses. Turnover is calculated by reference to the value of work performed to date as a proportion of the total contract value.

Fixed assets

Tangible fixed assets are included at their original historic cost.

Depreciation of tangible fixed assets is calculated on a straight line basis at rates estimated to write down the cost of each asset to its estimated residual value over its useful life.

Expected useful lives are as follows:

Leasehold improvements	– ten years from commencement of lease
Plant and machinery	– five years
Computer equipment	– three years

The carrying values of tangible fixed assets are reviewed for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Any impairment in the value is charged to the profit and loss account. Profits or losses on disposal of fixed assets reflect the difference between net selling price and net book value at the date of disposal.

Investments

Investments in subsidiary undertakings are stated in the parent company's accounts at cost, less provisions for any impairment in value.

Short term investments

Short term investment balances comprise cash held at banks which are not readily accessible.

Stocks

Stocks are stated at the lower of cost and net realisable value with due allowance for any obsolete or slow moving items.

Net realisable value is based on estimated selling price less any further costs expected to be incurred to completion and disposal.

Stocks held for demonstration purposes are held at original cost and amortised over a period of no more than twelve months.

Provisions for liabilities and charges

A provision is recognised when the Group has a legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation.

Provision for product warranty

This relates to estimated warranty costs which are expected to be incurred under the Company's terms and conditions of sale.

The costs are expected to arise between one and two years of the balance sheet date.

Taxation

The charge for taxation is based on the loss for the year and takes into account taxation deferred because of timing differences between the treatment of certain items for taxation and accounting purposes.

Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where transactions or events have occurred at that date that will result in an obligation to pay more, or a right to pay less or to receive more, tax, with the following exceptions:

- deferred tax assets are recognised only to the extent that the directors consider that it is more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted.

Deferred tax is measured on an undiscounted basis at the tax rates that are expected to apply in the periods in which timing differences reverse, based on tax rates and laws enacted or substantively enacted at the balance sheet date.

Foreign currencies

Company

Transactions in foreign currencies are recorded at the rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date. All differences are taken to the profit and loss account.

Group

The financial statements of overseas subsidiary undertakings are translated at the rate of exchange ruling at the balance sheet date. The exchange difference arising on the translation of the opening net assets is taken directly to reserves. All other translation differences are taken to the profit and loss account.

Research and development

Research and development expenditure is charged to the profit and loss account as incurred.

Leasing commitments

Rentals payable under operating leases are charged in the profit and loss account on a straight line basis over the lease term.

Pensions and other post-retirement benefits

The Group makes defined contributions to employee personal pension plans. The pension cost charged to the profit and loss account represents the contributions payable to the pension plans in respect of the accounting year.

Long term contracts

Amounts recoverable on long term contracts, which are included in debtors, are stated at the net sales value of the work done less amounts received as progress payments on account. Excess progress payments are included in creditors as payments on account.

NOTES TO THE FINANCIAL STATEMENTS at 31 December 2005

2. TURNOVER AND SEGMENTAL ANALYSIS

In the opinion of the directors, the Group has only one class of business and turnover and losses were generated predominantly in the United Kingdom.

Geographical analysis of turnover by destination:	2005 £000	2004 £000
North America	2,077	1,161
United Kingdom	452	346
Rest of Europe	589	107
Asia	350	116
	3,468	1,730

Geographical analysis of net assets by location:	2005 £000	2004 £000
North America	775	316
United Kingdom	10,267	4,483
	11,042	4,799

3. OPERATING LOSS

This is stated after charging/(crediting):

	2005 £000	2004 £000
Auditors' remuneration – audit services [†]	59	47
– non-audit services	161	19
Depreciation and impairment of fixed assets	534	1,180
Rentals received under operating leases	(131)	(161)
Operating lease rentals – land and buildings	357	429
Foreign exchange charge	86	140
Research and development	2,962	2,929
Loss on disposal of plant and machinery	—	10

[†] Auditors' remuneration noted above includes £12,000 (2004: £nil) related to the audit of the parent company. Non-audit fees relate to general taxation advice totalling £13,000 and taxation advice relating to the Group restructuring totalling £148,000. In addition to the above amounts, the auditors also received £207,000 in respect of audit and non-audit services relating to the listing. These costs have been booked against the share premium account in line with FRS 4.

4. EXCEPTIONAL ITEMS

	2005 £000	2004 £000
Recognised in arriving at operating loss:		
Impairment of tangible fixed assets	—	1,006
Transaction costs	315	—
	315	1,006

In 2004 the directors performed a review of the carrying value of fixed assets and, based upon their forecast of the Company's future operating cashflows, determined that an impairment charge of £1,005,595 was warranted.

In 2005 there is an exceptional item of £315,000 that relates to costs associated with the flotation of the Company but which are not considered to be direct costs of the share issue.

5. STAFF COSTS

(a) Staff costs

	2005 £000	2004 £000
Wages and salaries	3,989	3,316
Social security costs	450	382
Other pension costs	364	335
	4,803	4,033

The average monthly number of employees during the year was made up as follows:

	2005 Number	2004 Number
Production and customer support	40	33
Research and development	26	22
Sales and marketing	12	8
Administration	10	10
	88	73

(b) Directors' emoluments

	2005 £000	2004 £000
Directors' emoluments	529	300
Company contributions paid to the defined contribution scheme	37	26
Aggregate gains made by directors on the exercise of options	—	—
Number of directors accruing benefits under defined contribution schemes	3	5

The amounts in respect of the highest paid director are as follows:

	2005 £000	2004 £000
Emoluments	288	266
Company contributions paid to the defined contribution scheme	21	23

6. INTEREST PAYABLE AND SIMILAR CHARGES

	2005 £000	2004 £000
Other loans	190	—

7. TAX

(a) Tax credit on ordinary activities

The tax credit is made up as follows:

	2005 £000	2004 £000
Current tax:		
UK corporation tax credit	—	—
R&D tax credits for the year	484	400
Adjustment in respect of prior years	51	77
Total current tax credit	535	477

NOTES TO THE FINANCIAL STATEMENTS at 31 December 2005

7. TAX (CONTINUED)

(b) Factors affecting current tax credit

The tax credit on the loss of ordinary activities for the year is lower (2004: lower) than the standard rate of corporation tax in the UK of 30% (2004: 30%). The differences are reconciled below:

	2005 £000	2004 £000
Loss on ordinary activities before tax	(8,971)	(8,959)
Loss on ordinary activities multiplied by standard rate of corporation tax in the UK of 30% (2004: 30%)	(2,691)	(2,688)
Expenses not deductible for tax purposes	114	76
Decelerated capital allowances	155	244
Losses arising in the year not utilised	2,819	1,176
Movement in short term timing differences	35	2
Unrealised exchange movement	(1,037)	690
Losses surrendered for R&D tax credit	121	100
Adjustments in respect of previous years	(51)	(77)
Total current tax (note 7(a))	(535)	(477)

(c) Factors that may affect future tax charges

A deferred tax asset has not been recognised in respect of differences relating primarily to tax losses as there is insufficient evidence that the asset will be recovered, due to the uncertainty regarding the timing of relief and in the US, the quantum of losses that will be available to set against profits arising in the future. The amount of the asset not recognised is £10.0 million (2004: £7.7 million).

The unrecognised deferred tax asset is comprised of the following elements.

	2005 £000	2004 £000
Tax losses	9,077	6,898
Decelerated capital allowances	908	747
Other timing differences	52	55
	10,037	7,700

8. LOSS ATTRIBUTABLE TO MEMBERS OF THE PARENT COMPANY

The loss on ordinary activities after taxation includes a loss of £384,000 attributable to the parent company.

9. LOSS PER ORDINARY SHARE

Basic loss per share for the year ended 31 December 2005 of 47.7p per ordinary share is calculated using 17,699,035 shares, being the weighted average number of shares that would have been in issue had the shares been issued on 1 January 2005.

For the year ended 31 December 2005, the loss attributable to ordinary shareholders and weighted average number of shares for the purpose of calculating the diluted loss per share are identical to those used for the basic loss per ordinary share. This is because the potential diluting effect of reducing the loss per ordinary share is not dilutive under the terms of FRS 22 Earnings per share.

10. TANGIBLE FIXED ASSETS

Group

	Leasehold improvements £000	Plant and machinery £000	Computers £000	Total £000
Cost				
At 1 January 2005	2,973	7,946	1,185	12,104
Additions	121	324	8	453
At 31 December 2005	3,094	8,270	1,193	12,557
Depreciation				
At 1 January 2005	1,284	7,209	1,106	9,599
Charge for the year	286	199	49	534
At 31 December 2005	1,570	7,408	1,155	10,133
Net book value at 31 December 2005	1,524	862	38	2,424
Net book value at 31 December 2004	1,689	737	79	2,505

11. INVESTMENTS

Company

£000

Shares in Group undertakings:

Additions 12,989

At 31 December 2005

12,989

The increase in investments represents the transfer within the Group of the investment in SPI Lasers UK Ltd from Southampton Photonics, Inc. during the year.

Shares in Group undertakings represent the Company's investment in the following entities:

Name of company	Holding	Proportion of voting rights and shares held	Country of incorporation	Nature of business
SPI Lasers UK Limited	Ordinary shares	100%	England	Optical fibre-based lasers
SPI Lasers LLC	Declared 100% interest	100%	United States	Optical fibre-based lasers

Southampton Photonics, Inc. was liquidated during the year.

12. STOCKS

Group

	2005 £000	2004 £000
Raw materials and component parts	789	322
Work in progress	508	141
Finished goods	787	113
	2,084	576

The difference between purchase price or production cost of stocks and their replacement cost is not material.

13. DEBTORS

	Group		Company
	2005 £000	2004 £000	2005 £000
Trade debtors	1,280	176	—
Amounts owed by Group undertakings	—	—	2,883
Other debtors	532	201	3
Prepayments and accrued income	390	522	8
Corporation tax recoverable	484	400	—
	2,686	1,299	2,894

14. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	Group		Company
	2005 £000	2004 £000	2005 £000
Loans (note 16)	628	—	—
Payments received on account	95	137	—
Trade creditors	997	558	10
Other creditors including taxation and social security	353	163	25
Accruals and deferred income	1,001	514	214
	3,074	1,372	249

15. CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR

	Group		Company
	2005 £000	2004 £000	2005 £000
Loans (note 16)	1,039	—	—
Amounts owed to Group undertakings	—	—	12,192
	1,039	—	12,192

16. LOANS

	Group		Company
	2005 £000	2004 £000	2005 £000
Amounts falling due: in one year or less or on demand	628	—	—
In more than one year but not more than two years	714	—	—
In more than two years but not more than five years	325	—	—
	1,667	—	—
Less: included in creditors: amounts falling due within one year	628	—	—
	1,039	—	—

The loan was provided in June 2005 by ETV Capital SA (Luxemburg). The loan amount was £2,000,000, repayable by 36 equal monthly instalments at an interest rate of 12.65%. It is secured on the fixed assets of the Company.

ETV Capital SA has been granted a warrant to purchase, at its discretion, 201,388 ordinary shares at the IPO price of 144p per share.

The warrant is exercisable for the greater of ten years from the date of issue or five years after the initial public offering of the company's ordinary shares. The warrant may be exchanged without the payment of any additional consideration for the company's shares based upon the value of the warrant and the shares at the time of the exchange.

17. OBLIGATIONS UNDER LEASES

Annual commitments under non-cancellable operating leases are as follows:

Group	2005	Land and buildings
	£000	2004 £000
Operating leases which expire:		
Within one year	—	27
In two to five years	—	—
In over five years	325	325
	325	352

18. PROVISIONS FOR LIABILITIES AND CHARGES

Group	Dilapidations	Product warranty	Total
	£'000	£'000	£000
At 1 January 2005	70	33	103
Arising during the year	25	75	100
Amounts utilised during the year	(18)	(20)	(38)
At 31 December 2005	77	88	165

Dilapidations

Provision is made for potential dilapidations to a building for which the lease has expired. The Company vacated the building in September 2005. The provision is expected to be utilised during 2006.

Product warranty

Provision is made for estimated warranty costs which are expected to be incurred under the Company's terms and conditions of sale. These costs are expected to arise between one and two years of the balance sheet date.

19. DERIVATIVES AND OTHER FINANCIAL INSTRUMENTS

An explanation of the Group's objectives, policies and strategies for the role of derivatives and other financial instruments in creating and changing the risks of the Group in its activities is discussed in this note. The disclosures below exclude short term debtors and creditors.

Interest rate risk profile of financial liabilities

The interest rate profile of the financial liabilities of the Group as at 31 December is as follows:

	Total £000	Fixed rate Financial liabilities £000
2005		
Sterling – borrowings	1,667	1,667
2004		
Sterling	—	—
	Weighted average interest rate %	Weighted average period for which rate is fixed Years
2005		
Sterling – borrowings	12.65	2.4
2004		
Sterling	—	—

Interest rate risk profile of financial assets

The interest rate profile of the financial assets of the Group as at 31 December is as follows:

	Total £000	Fixed rate financial assets £000	Floating rate financial assets £000	Financial assets on which no interest is earned £000
2005				
Sterling	7,887	—	7,887	—
US dollar	239	—	239	—
Total	8,126	—	8,126	—
2004				
Sterling	965	—	965	—
US dollar	929	—	929	—
	1,894	—	1,894	—

Floating rate financial assets comprise cash deposits on money market deposit at call.

Currency exposures

The Group does not hedge the currency exposures arising from its net investment overseas (in other words, its structural currency exposures). Gains and losses from these structural currency exposures are recognised in the statement of total recognised gains and losses.

The table below shows the Group's currency exposures; in other words, those transactional exposures that give rise to the net currency gains and losses recognised in the profit and loss account. Such exposures comprise the monetary assets and monetary liabilities of the Group that are not denominated in the operating (or 'functional') currency of the operating unit involved.

Net foreign currency monetary assets/(liabilities)

Functional currency of Group operations	Total £000	Euros £000	US dollar £000
2005			
Sterling	99	50	49
2004			
Sterling	581	(18)	599

NOTES TO THE FINANCIAL STATEMENTS at 31 December 2005

19. DERIVATIVES AND OTHER FINANCIAL INSTRUMENTS (CONTINUED)

Maturity of financial liabilities

The maturity profile of the Group's financial liabilities at 31 December is as follows:

	2005 £000	2004 £000
In one year or less, or on demand	628	—
In more than one year but not more than two	714	—
In more than two years, but not more than five	325	—
	1,667	—

Borrowing facilities

The Group has no further borrowing facilities available to it, other than the loan with ETV Captial SA (Luxemburg).

Fair values of financial assets and financial liabilities

Set out below is a comparison by category of book values and fair values of the Group's financial assets financial liabilities as at 31 December:

	Book value 2005 £000	Fair value 2005 £000	Book value 2004 £000	Fair value 2004 £000
Primary financial instruments				
Short term borrowings and current portion of long term borrowings	628	628	—	—
Current asset investment	—	—	256	256
Long term borrowings	1,039	1,039	—	—
Cash and short term deposits	8,126	8,126	1,638	1,638

Market price risk

The Group accepts a degree of interest rate risk and currency risk as long as the effects of various changes in rates remain within certain prescribed ranges.

20. SHARE CAPITAL

The authorised and issued share capital of the Company as at 31 December 2005 is as follows:

Authorised	2005 Number	2005 £000
Ordinary shares of £0.025 each	100,000,000	2,500
Alotted, called up and fully paid	2005 Number	2005 £000
Ordinary shares of £0.025 each	17,699,035	442

On incorporation on 25 August 2005, the authorised share capital was 100,000 ordinary shares at £0.001 each. On 20 October 2005, the Company passed the following resolutions:

- i) the share capital of the Company was increased from £100,000 to £2,500,000 by the creation of a further 2,400,000,000 ordinary shares of £0.001 each.
- (ii) the Company consolidated its share capital on a 25:1 basis, consolidating 25 ordinary shares of £0.001 each into one ordinary share of £0.025 each

On 20 October 2005, the former shareholders of Southampton Photonics, Inc. exchanged their shares for ordinary shares in SPI Lasers plc. As a result, 9,362,994 ordinary shares of £0.025 each with an aggregate nominal value of £234,075 were issued at par.

On 20 October 2005, 8,336,041 ordinary shares of £0.025 each with an aggregate nominal value of £208,401 were issued at £1.44 per share with total gross consideration amounting to £12,003,899. Share issue costs netted against the share premium account total £1,190,000.

Share options

The number of options outstanding under the Company's share option scheme is disclosed in the directors' report. There are no additional options granted to employees, other than directors as at 31 December 2005.

21. RESERVES

Group

	Share capital reserve £000	Share premium account £000	Merger reserve £000	Profit and loss account £000	Total £000
On incorporation	50	—	—	—	50
Repurchase of initial shares issued	(50)	—	—	—	(50)
Merger accounting	234	—	50,389	(41,983)	8,640
Arising on share issues	208	11,795	—	—	12,003
Share issue costs	—	(1,190)	—	—	(1,190)
Retained loss for the year	—	—	—	(8,436)	(8,436)
Exchange differences on retranslation of net assets of subsidiary undertakings	—	—	—	25	25
At 31 December 2005	442	10,605	50,389	(50,394)	11,042

Company

	Share capital £000	Share premium £000	Profit and loss account £000	Total £000
On incorporation	50	—	—	50
Repurchase of initial shares issued	(50)	—	—	(50)
Arising on share issues	442	11,795	—	12,237
Share issue costs	—	(1,190)	—	(1,190)
Retained loss for the year	—	—	(384)	(384)
At 31 December 2005	442	10,605	(384)	10,663

SPI Lasers plc Group restructuring

SPI Lasers plc was incorporated on 25 August 2005 under the name of Wilmerhale 1 plc and changed its name to SPI Lasers plc on 30 August 2005. It became the ultimate parent company to SPI Lasers LLC under the 'Merger Agreement' which became effective on 26 October 2005.

Under the terms of the Merger Agreement, shares in the Company were offered to existing shareholders of Southampton Photonics, Inc. The details of the Merger Agreement were as follows:

- each share of issued common stock in Southampton Photonics, Inc. of \$0.001 (30,851,938) was exchanged for one ordinary share in SPI Lasers plc of £0.001;
- each share of issued Series A preferred stock in Southampton Photonics, Inc. of \$0.001 (49,448,336) was exchanged for 1.4016 fully paid ordinary shares in SPI Lasers plc of £0.001; and
- each share of issued Series B preferred stock in Southampton Photonics, Inc. of \$0.001 (153,769,332) was exchanged for 0.8709 fully paid ordinary shares in SPI Lasers plc of £0.001.

The ordinary shares in SPI Lasers plc were consolidated on a ratio of 1:25 pre-IPO, reducing the number of ordinary shares in the Company but making no change to the share capital.

NOTES TO THE FINANCIAL STATEMENTS at 31 December 2005

22. RELATED PARTY TRANSACTIONS

The University of Southampton is a related party under FRS 8 as David Payne, a director of SPI Lasers plc, is an employee of the University. Included within the profit and loss account are costs of £172,000 (2004: £107,000) in respect of a series of technology development contracts with the University. Purchases of goods and services made from the University of Southampton amounted to £66,000 (2004: £17,000). Royalties of £23,000 (2004: £30,000) were due to the University under licence agreements. The year end balance with the University totalled £83,000 (2004: £61,000) and is included within accruals. All transactions were conducted on an arm's length basis.

23. NOTES TO THE STATEMENT OF CASH FLOWS

(a) Reconciliation of operating loss to net cash outflow from operating activities

	2005 £000	2004 £000
Operating loss	(8,942)	(9,044)
Depreciation charges	534	1,180
Fixed asset impairment charges	—	1,006
Loss on disposal of fixed assets	—	10
(Increase)/decrease in debtors	(1,303)	288
Increase in stocks	(1,508)	(436)
Increase in creditors	1,136	44
Exchange difference	86	134
Net cash outflow from operating activities	(9,997)	(6,818)

(b) Reconciliation of net cash flow to movement in net funds

	2005 £000	2004 £000
Increase/(decrease) in cash in the year	6,549	(1,895)
Cash inflow from increase in debt finance	(2,565)	—
Cash outflow from decrease in debt	898	—
(Decrease)/increase in liquid resources	(256)	127
Change in net debt resulting from cash flows	4,626	(1,768)
Exchange differences	(61)	245
Movement in net debt in the year	4,565	(1,523)
Opening net funds	1,894	3,417
Closing net funds	6,459	1,894

(c) Analysis of net debt

	At 1 January 2005 £000	Cash flow £000	Exchange differences £000	At 31 December 2005 £000
Cash at bank and in hand	1,638	6,549	(61)	8,126
Liquid resources	256	(256)	—	—
Loans – short term	—	(628)	—	(628)
Loans – long term	—	(1,039)	—	(1,039)
	1,894	4,626	(61)	6,459

(d) Major non-cash transactions

There were no major non-cash transactions in the year.

(e) Exceptional items

Cash flows relating to operating exceptional items

There were cash flows of £315,000 relating to operating exceptional items in the year (2004: £nil)

24. PENSION SCHEMES

The Group pays contributions to personal pension plans for directors and employees. These contributions are charged to the profit and loss account as they arise. Contributions made during the year amounted to £359,000 (2004: £334,000).

The Group pays contributions to a 401k pension plan for US employees. These contributions are charged to the profit and loss account as they arise. Contributions made during the year amounted to £5,000 (2004: £1,000).

25. CAPITAL COMMITMENTS

Amounts contracted for but not provided in the financial statements amounted to £nil (2004: £43,054) for the Group and £nil for the Company (2004: £nil).

26. CONTINGENT LIABILITIES

The directors are not aware of any contingent liabilities.

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