STATEMENT OF JAY SMITH

Good morning. My name is Jay Smith, and I am the Chief Financial Officer of Xcaliber International. I have been in my current position for approximately 2 and a half years, and, prior to joining Xcaliber, I was the CFO of a safety equipment manufacturer for the oil and gas industries for the previous 9 years. As CFO, I have responsibilities in regard to strategic planning, financial planning, financial reporting, and cash flow management.

I wanted to share with you today about some of the competitive challenges facing the US 4th Tier cigarette industry – including how we deal with MSA states, competing in a highly regulated industry, which involves constraints on innovation or changes to products. And of course, the threat posed to our company and our industry by the recent surge in imports from Korea.

The CFO position with Xcaliber was an attractive opportunity, including structuring an IPO for a growing company. And as I'll discuss later, it was an IPO that failed in very large part due to unfair competition with low priced Korean cigarettes. As I mentioned, I joined the company to assist with an IPO attempt, and, in this regard, the first time I really became aware of KT&G was in the 4th quarter of 2017. At this time we started to see a softening of our sales volume, and this was due to competitive attacks by the Korean producer of cigarettes – KT&G. At that time, one of our senior sales people let us know that KT&G was taking sales away from us and urged us to do something to protect volume. However, we were in the IPO process and the CEO at the time said, "No more rebates. We're not going to try to match Korean prices. We should just stay the course." And that's what we did. As a result we saw a sales decline in the 4th quarter of 2017 and the 1st quarter of 2018. So then, we knew we had to do something. We knew we had to change course. Wholesalers were telling us that they wanted more rebates in order for us to stay competitive with Korean prices. (It's important to note that in our industry the net price frequently includes rebates to wholesalers and often to retailers as well.)

So, in an attempt to compensate for a decrease in sales volume we tried to get a price increase in Missouri, but this only pushed us into a greater sales volume decline. At this point, our sales team was adamant that we needed to offer more rebates to stay competitive with KT&G. We were losing volume in our traditional core area – Oklahoma and many of the surrounding states. We also knew that because Missouri is so crucial to our business, if KT&G really started to take market share in that state that the viability of our company would be in question. So in June 2018, in part to protect our market in Missouri, we started to offer more rebates to compete with KT&G. And so, our net prices continued to decline. And then, in June 2018, the IPO was called off. This was due in part to the negative effect of KT&G's sales on cash flow. Without a doubt, KT&G contributed to our IPO failing.

The 4th tier is a small industry of 4 or so players, and it has a unique requirement to have huge amount of restricted cash. Because of the escrow payments that we're required to make as a matter of law, for every carton we sell, we have to hold back a certain amount of cash. These monies are locked up for 25 years and can cost us $10 million per quarter. Its more like an expense, as it reduces cash flow. Most businesses project 3-5 years down the road, but we've got restricted assets for at least 25 years. And, anything can happen in 25 years. We may get these deposits back, but we may not. So in reality, we have to watch every dollar in a way that our top line might not immediately suggest. For us, it really is about operating performance post-escrow.

This is how the industry operates and we can and have done this successfully up to this point even with the requirement to have such large amounts of restricted cash. However, as imports came in – we lost sales and we had decreased net prices – so after our escrow payments we have even less cash on hand. The decreased cash flow due to decreased revenues caused by Korean imports affects our ability to make capital expenditures and to invest in R&D.

Now, I'd like to focus on where we are today and what the future looks like. Our IPO failed – as I said in large part because of the net pricing of KT&G in the market. You should know that their net selling price is more than a dollar or two per carton lower than the prevailing U.S. price. They're priced lower than everybody. And, as I also said, this affects our cash flow. But then we see this massive surge in 2019, and this is what worries me today. We don't have the ability to raise net prices and maintain volumes because of KT&G, so cash flow minimizes. If cash flow goes negative then you have to go to debt financing. And due to the nature of the industry, banks are only going to allow you to finance so much. At that point, we have to make very difficult decisions as to how we operate and whether we want to continue the business.

With our cash flow situation, I've told the owners we need to squeeze out every efficiency because we don't have the money to build new offices or buy new equipment. We buy used equipment, or we have to retool existing equipment. R&D is in the same position. Of course it would be nice to have our own R&D lab, but we don't have the cash flow to expand the lab with the situation we're in. Even though we can't expand the lab, we nevertheless have to invest large sums of money into R&D to comply with FDA regulations. Due to the effects of KT&G on the business, we are not able to invest in a way that would ultimately save us money.

And I cannot emphasize this enough: at the end of 2019, because of KT&G pricing, our cash flow was at or near zero for the year. Which pretty much says it all.

There are now conversations with the owners regarding minimizing cash outflow so - as an example – employee bonuses will not be paid in 2020. We're going to have to look at pay cuts. We're looking at layoffs or letting people go if cash flow doesn't improve. We don't want to do this, but we may have no choice.

If the Korean imports continue things could go down two different paths but they both end in the same location. The first path is if we decrease prices in order to try to match the falling Korean prices. If this happens, then over the next 18 months or so, not only will we not increase net pricing, but it will fall, and with escrow payments increasing by 3% per year we'll have declining cash flow. With a zero cash flow in 2019 we would be negative in 2020. So we would have to take on debt financing just to pay the bills.

Or the second path is that we try to maintain prices but then we'll lose more sales volume to KT&G. Which will also result in decreased cash flow and again lead to debt financing.

Either way, without relief, we'll end at the same place. Either we lose volume or price or both, we go into debt, more money goes to the interest expense, we can't pay the principal, and then you're in the death spiral.

What KT&G is doing is destroying the viability of our company. Morale throughout the company is at an all-time low. We're a small company and our people are getting discouraged and upset. And, people are now getting scared.

If we get relief, this could be a good business. All we want is a level playing field. We can be a strong growing operation that takes care of its people and builds manufacturing in Oklahoma. But in the absence of trade relief, the writing is on the wall.

Thank you.