



# ***Quarterly Report***

***December 31, 2016***



# Nanotech Security Corp.

Management's Discussion and Analysis  
For the three months ended December 31, 2016

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For purposes of this management discussion and analysis ("MD&A"), "Nanotech", the "Company", "we", or "us" refers to Nanotech Security Corp. and its subsidiaries. This quarter means the three months ended December 31, 2016.

## ADVISORY

This MD&A dated as of February 24, 2017, should be read in conjunction with the cautionary statement regarding forward-looking statements below and the Company's condensed consolidated interim financial statements for the three months ended December 31, 2016 as well as with the Company's consolidated financial statements and MD&A for the year ended September 30, 2016. The results reported herein have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") and are presented in Canadian dollars. All quarterly information disclosed in the MD&A is unaudited.

Additional information relating to the Company is filed on SEDAR at [www.sedar.com](http://www.sedar.com).

## FORWARD-LOOKING STATEMENTS

*The following discussion and analysis of the financial conditions and results of operations contains forward-looking statements concerning anticipated developments in the Company's operations in future periods, the adequacy of Nanotech's financial resources, and the events or conditions that may occur in the future. Forward-looking statements are frequently, but not always, identified by words such as "expects", "anticipates", "believes", "intends", "estimates", "predicts", "potential", "targeted" "plans", "possible" and similar expressions, or statements that events, conditions, or results "will", "may", "could" or "should" occur or be achieved.*

*These forward-looking statements include, without limitation, statements about the Company's market opportunities, strategies, competition, and the Company's views that its optics based technologies will continue to show promise for large scale production. Other forward-looking statements imply that the Company will remain capable of being financed and/or will be able to partner development until profitability is eventually realized. The principal risks related to these forward-looking statements are that the Company's products receive market acceptance, that its intellectual property claims will be sufficiently broad or enforceable to provide the necessary protection or attract the necessary capital.*

*These forward-looking statements are based on the beliefs, expectations and opinions of management on the date the statements are made. Consequently, all forward-looking statements made in this discussion and analysis of the financial conditions and results of operations or the documents incorporated by reference, are qualified by this cautionary statement and there can be no certainty that actual results or developments the Company anticipates will be realized. For additional information with respect to certain of these risks or factors reference should be made to the "Business Risks and Uncertainties" section of the management discussion and analysis and notes to the consolidated financial statements for the year ended September 30, 2016, as well as with the Company's continuous disclosure materials filed from time to time with Canadian securities regulatory authorities, which are available online at [www.sedar.com](http://www.sedar.com). Nanotech disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than as required by law. Caution needs to be used when taking forward-looking statements into account when evaluating the Company.*

## GENERAL OVERVIEW

Nanotech is incorporated under the laws of British Columbia, is listed on the TSX Venture Exchange (trading symbol: NTS) and quoted in the United States on the OTCQX Market (trading symbol: NTSFF). The Company's head office is located at #505 - 3292 Production Way, Burnaby, BC, Canada V5A 4R4. The Company's registered and records office is #1500 - 1055 West Georgia, Vancouver, BC, Canada V6E 4N7.

The Company operates its business through two business divisions - Optics and Tactical. The Company's reportable segments are strategic business divisions that offer different products and services. They are

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managed separately as each business is in a different stage in its life cycle and they require different sales and marketing strategies.

## **Optics**

The Optics division (previously named Security Features) designs, manufactures and markets nano-optic optical variable devices ("OVDs") and optical thin film ("OTF") products. These products have brand authentication and enhancement applications across a wide range of markets including banknotes, secure government documents, commercial branding, and the pharmaceutical industry. Nanotech is initially focusing its efforts on the banknote market due to its high margins and the Company has established a very strong customer base.

The Company's nano-optic technology employs arrays of billions of nano-indentations that are impressed or embossed onto a substrate material such as polymer, paper, metal, or fabric. By using sophisticated algorithms to direct an electron beam, the Company creates arrays of unique light signatures (visual images). These nano-indentation structures create images with colour-shifting effects that provide visual features such as 3D, high-definition, and motion-impression, and can also display distinct colours including skin tones, white, and black; which are not possible using current holographic technology.

The OTF technology security features are manufactured using precision engineered nanometer thick layers of metals and ceramics to form filters designed to uniquely manipulate visible and non-visible light. This unique manipulation of light properties is used to create specialized security features in the form of threads, stripes and patches that are applied to banknotes and other secure documents. By using sophisticated electron beam and sputtered deposition methods Nanotech precisely controls the construction and inherent properties to provide custom tailored colour-shifting solutions. An individual looking at these threads, stripes and patches sees an obvious colour-shift (e.g. green to magenta) when it is tilted or rotated.

## **Tactical**

The Company's legacy Tactical division (previously named Surveillance) designs and sells a wide range of sophisticated surveillance and officer protection equipment and conducts technical surveillance training for the law enforcement and defense industries in the United States and Canada. These products include outfitting surveillance vans for covert operations, mobile command centre trailers, and services include teaching accredited classes in electronic surveillance. The Tactical division conducts research, production, and training at its facility in Holmes, PA, USA.

The Tactical division customizes surveillance vans for government agencies and has successfully developed surveillance products, including most recently the P-25 digital transmission system allowing federal, state and local law enforcement agencies to communicate with each other over a single frequency using both digital and analog frequencies, and the release of the Echo 8i that converts analog audio signals to digital, enabling secure smart phone wireless connectivity.

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For the three months ended December 31, 2016

## RESULTS OF OPERATIONS

Select financial information for the three months ended December 31, 2016 and 2015:

### Select Financial Information

	Three months ended December 31,	
	2016	2015
Revenue	\$ 907,013	\$ 1,509,240
Cost of sales	275,737	760,820
	631,276	748,420
Expenses		
Research and development	445,081	558,197
General and administration	656,577	647,689
Sales and marketing	472,903	548,776
Depreciation and amortization	724,034	770,157
	2,298,595	2,524,819
Loss before other expenses	(1,667,319)	(1,776,399)
Other expenses (income)	185,961	(30,064)
Net loss	\$ (1,853,280)	\$ (1,746,335)

### Revenue

Consolidated revenues for the three months ended December 31, 2016 decreased by \$602,227 or 40% to \$907,013 compared to \$1,509,240 in the same period last year. Optics revenue was up \$125,004 compared to last year primarily due to increased revenue from development contracts, however Tactical's revenue was lower by \$727,231 because of lower surveillance van work.

Customer paid development activities are progressing well and we continue to advance our nano-optic based technologies into the development of new security features for banknotes. During the quarter, development revenue amounted to over \$600,000 and it is anticipated to grow. In addition, the Company had started on a new development project and has capitalized \$117,018 in inventory at December 31, 2016, although the Company had not yet been formally awarded the contract at that time. Subsequent to the quarter end, the Company has finalized the agreement, and will recognize revenue during the second quarter.

The Company continues to work with its Asian customer to finalize the product specifications and integrate our OTF into the customer's production facility. Initial deliveries from our Austrian partner continue to be scrutinized and reviewed by the customer as they work to ensure they are seamlessly integrated into their production facility. Management expects our production partner to demonstrate their ability to produce OTF that meets the customer expectation later in 2017.

Revenues from Tactical for the three months ended December 31, 2016 decreased to \$212,542 from \$939,773 in the same period last year. This decrease reflects the large delivery of surveillance vans in the first quarter of last year, which did not occur in the current quarter. The Tactical division will continue to have fluctuations in their quarterly revenue as it is highly dependent on the timing of surveillance van and product deliveries.

### Gross Margin

Gross margin for the three months ended December 31, 2016 decreased by \$117,144 or 16% to \$631,276 compared to \$748,420 in the same period last year. Overall, the gross margin percentage improved to 70% for the three months ended December 31, 2016, an increase from 50% in the same period last year. The gross margins continue to reflect strong margins in the Optics division.

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## Research and Development

Research and development expenditures for the three months ended December 31, 2016 decreased by \$113,116 or 20% to \$445,081 compared to \$558,197 in the same period last year. During the quarter, \$98,795 was capitalized to work-in-progress as the Company began work on a development contract in advance of being formally awarded the contract. Subsequent to the quarter end, the development contract was awarded and the revenue and associated costs will be recognized in the second quarter.

## General and Administration

General and administration expenditures for the three months ended December 31, 2016 were \$656,577, an increase of \$8,888 or 1% compared to \$647,689 in the same period last year which reflects consistent overhead costs over the two periods.

## Sales and Marketing

Sales and marketing expenditures for the three months ended December 31, 2016 were \$472,903, a decrease of \$75,873 or 14% compared to \$548,776 in the same period last year. The decrease mainly relates to a reduction in travel related costs in the Optics division along with lower salaries in the Tactical division.

## Depreciation and Amortization

Depreciation and amortization expenditures for the three months ended December 31, 2016 were \$724,034, consistent with the \$770,157 in the same period last year.

## Other Expenses

Other expenses for the three months ended December 31, 2016 were \$185,961 an increase of \$216,025 compared to income of \$30,064 in the same period last year. The increase mainly relates to the interest on the convertible debentures.

## Net Loss

The net loss for the three months ended December 31, 2016 was \$1,853,280 compared to \$1,746,335 during the same period last year. The increase in net loss reflects a decrease in revenues, which was partially offset by higher margins. Expenditures were comparable quarter over quarter apart from finance costs which increased by \$195,550 in the current quarter reflecting the new convertible debentures.

## SEGMENT RESULTS

The Company analyzes financial performance by segments, which group related activities within the Company. The Company's two reportable operating segments are Optics and Tactical. Inter-segment transactions have been eliminated from the segmented financial information discussed below.

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## Optics

The Optics division designs, manufactures and markets nano-optic OVDs and OTF products. These products have brand protection and enhancement applications across a wide range of markets including banknotes, secure government documents, commercial branding, and the pharmaceutical industry.

	Three months ended December 31,	
	2016	2015
Revenue	\$ 694,471	\$ 569,467
Net loss	(1,672,761)	(1,836,788)

Revenues from Optics for the three months ended December 31, 2016 increased to \$694,471 from \$569,467 for the same period last year. The increased revenue was primarily due to renewed development contracts at higher levels.

The loss from Optics for the three months ended December 31, 2016 improved by \$164,027 to \$1,672,761 from \$1,836,788 for the same period last year. The decrease in net loss reflects increased sales, partially offset by increased financing costs.

## Tactical

The Tactical division designs and sells a wide range of sophisticated surveillance and officer protection equipment and conducts surveillance training for the law enforcement and defense industries in the United States and Canada.

	Three months ended December 31,	
	2016	2015
Revenue	\$ 212,542	\$ 939,773
Net income (loss)	(180,519)	90,453

Revenues from Tactical for the three months ended December 31, 2016 decreased to \$212,542 from \$939,773 in the same period last year. This decrease reflects the large delivery of surveillance vans in the first quarter of last year, which did not occur in the current quarter. The Tactical division will continue to have fluctuations in their quarterly revenue as it is highly dependent on the timing of surveillance van and product deliveries.

The net loss from Tactical for the three months ended December 31, 2016 increased to \$180,519 from a net income of \$90,453 in the same period last year. The net loss was the result of decreased sales during the quarter.

## QUARTERLY RESULTS

	Q1 2017	Q4 2016	Q3 2016	Q2 2016	Q1 2016	Q4 2015	Q3 2015	Q2 2015
(\$ thousands, except common share amounts)								
Revenue	\$ 907	\$1,511	\$1,158	\$ 948	\$1,509	\$ 728	\$1,359	\$1,528
Net loss	(1,853)	(1,677)	(1,957)	(2,450)	(1,746)	(1,565)	(1,280)	(895)
Net loss per common share:								
Basic	(0.03)	(0.03)	(0.04)	(0.05)	(0.03)	(0.03)	(0.03)	(0.02)
Diluted	(0.03)	(0.03)	(0.04)	(0.05)	(0.03)	(0.03)	(0.03)	(0.02)

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There are no seasonal effects or other trends in the Company's business over the quarters presented. The decrease in revenue in Q1 2017 was due to reduced sales in Tactical during the quarter.

## RELATED PARTY TRANSACTIONS

For the period ended December 31, 2016, the Company had no transactions with related parties as defined in IAS 24, Related Party Disclosures, except those pertaining to transactions with key management personnel in the ordinary course of their employment or as disclosed below.

(a) Remuneration of key management personnel:

	Three months ended December 31,	
	2016	2015
Salaries, accrued bonuses, and employee benefits	\$ 223,365	\$ 300,704
Share-based payments	147,787	56,070
	<u>\$ 371,152</u>	<u>\$ 356,774</u>

(b) Management fees and accrued bonuses totaling \$79,800 for the three months ended December 31, 2016 (December 31, 2015 - \$121,500) by a company controlled by an officer and director of the Company, were included in salaries and benefits expense. As of December 31, 2016, amounts owing to this company included in accounts payable and accrued liabilities were \$333,751 (September 30, 2016 - \$285,509).

(c) Legal and professional fees, taxes and disbursements totaling \$34,553 for the three months ended December 31, 2016 (December 31, 2015 - \$21,486) were incurred with a law firm of which a director of the Company is a partner. As of December 31, 2016, amounts owing to this company included in accounts payable and accrued liabilities were \$58,718 (September 30, 2016 - \$52,826).

The above transactions are in the normal course of business and are measured at the exchange amount which is the amount of consideration established and agreed to by the related parties.

## LIQUIDITY AND CAPITAL RESOURCES

The Company's principal sources of liquidity are cash provided by operations, including collection of accounts receivable, and access to equity capital resources. The Company's primary short-term cash requirement is to fund operations, working capital, including supplier payables, capital expenditures, and fixed overhead costs. Cash is also used to finance other long-term strategic business initiatives. As at December 31, 2016, cash and cash equivalents totaled \$2,306,141, compared to \$3,312,691 as at September 30, 2016.

### Summary of Statements of Cash Flows

	Three months ended December 31,	
	2016	2015
Cash used in operating activities <sup>1</sup>	\$ (850,507)	\$ (904,312)
Changes in operating assets and liabilities	(138,727)	(283,264)
Cash used in operating activities	(989,234)	(1,187,576)
Cash used in investing activities	(14,619)	(168,434)
Cash provided by financing activities	23,000	-
Effect of foreign exchange on cash and cash equivalents	(25,697)	(29,586)
Cash and cash equivalents, beginning of period	3,312,691	3,021,928
Cash and cash equivalents, end of period	<u>\$ 2,306,141</u>	<u>\$ 1,636,332</u>

<sup>1</sup> Before changes in operating assets and liabilities

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For the three months ended December 31, 2016

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## Operating Activities

Cash used in operating activities was \$989,234 for the three months ended December 31, 2016, an improvement from the \$1,187,576 for the same period last year. This improvement was as a result of slightly improved operating burn during the quarter aided by an increase in cash collected from operating assets and liabilities.

## Investing Activities

Cash used in investing activities was \$14,619 for the three months ended December 31, 2016, compared to \$168,434 used in the same period last year. This reflects reduced expenditures on production equipment in the current quarter, as our production equipment upgrades were concluded early in the previous year.

## Financing Activities

Cash provided by financing activities was \$23,000 for the three months ended December 31, 2016, compared to \$nil during the same period last year. The current period reflects the proceeds on the exercise of stock options.

## Capital Resources

The Company's objectives when managing capital are to safeguard the ability to continue as a going concern, to provide adequate return to shareholders, to meet external capital requirements, and preserve financial flexibility in order to benefit from potential opportunities that may arise. Our principal cash requirements are for operations, working capital, and capital expenditures. The Company has recurring operating losses and an accumulated deficit of \$32,972,325 as of December 31, 2016. The Company expects to incur significant losses in the next year unless it is able to realize revenue after commercialization of its products under development. The timing and amount of such revenues, if any, cannot be predicted with certainty. The Company's ability to continue as a going concern is dependent on its ability to generate positive cash flows from operations or additional financing to meet its planned business objectives and to be able to commercialize products currently in development. The Company will need to raise funds and is pursuing additional funds through government grants, strategic collaborations, public or private equity or debt financing, or other funding sources. This funding may not be available or be available on acceptable terms, and will most likely be dilutive to shareholder interests. If the Company is unable to generate positive cash flows from operations or obtain adequate financing, the Company will need to curtail operations and development activities. These factors cast significant doubt regarding the Company's ability to continue as a going concern. Should the Company be unable to realize its assets and discharge its liabilities in the normal course of business the net realizable value of its assets may be materially less than the amounts in the consolidated statement of financial position.

The Company's officers are responsible for managing the Company's capital and do so through quarterly meetings and regular review of financial information. The Board of Directors is responsible for overseeing this process. In managing its capital, the Company considers changes in economic conditions, risks that impact consolidated operations, and future significant capital investment opportunities. For the three months ended December 31, 2016, there were no changes in our approach to capital management.

As at December 31, 2016 cash and cash equivalents amounted to \$2,306,141, compared to \$3,312,691 as at September 30, 2016.

The Company has a note payable outstanding of \$3,000,000 as at December 31, 2016. The note bears interest at 4% per annum and the principal is due in September 2017. Monthly interest payments are required prior to the maturity date. The note payable was used to finance some of the real estate assets acquired on the acquisition of Fortress Optical Features Ltd. The note payable is secured by the assets of the Company. The Company plans to repay or refinance the secured note through future debt or equity financing.

The Company has convertible debentures outstanding with a face value amounting to \$4,185,000 as at December 31, 2016 which will be repaid upon maturity on May 31, 2018. The convertible debentures accrue interest at a rate of 12% per annum payable quarterly in arrears and are convertible into common



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shares of the Company at a price of \$1.25 per share. The debentures are redeemable at the Company's option, at a price equal to their principal amount provided that the Company's common shares trade and close on the TSXV at or above \$2.00 for ten consecutive days.

The Company had no commitments for material capital expenditures as of December 31, 2016.

The Company had no lines of credit and no exposure to asset backed commercial paper.

Management has reviewed its projected funding requirements and expects that through the generation and collection of revenues and/or being able to raise additional financing, that the Company will maintain sufficient liquidity to meet its requirements through December 31, 2017.

## Financial Instruments

The Company considers the management of financial risk to be an important part of its overall corporate risk management policy. The nature and extent of risks arising from financial instruments and their related risk management are described in note 11 of the consolidated financial statements for the year ended September 30, 2016. In the three months ended December 31, 2016, there was no material change to the nature of the risks arising from our classification of financial instruments, or related risk management objectives.

## CAPITAL STRUCTURE AND OUTSTANDING SHARE DATA

The Company maintains an equity incentive plan consisting of a stock option plan and a restricted share unit ("RSU") plan to grant options and RSUs to eligible participants. The option plan permits the maximum number of shares that may be reserved for issuance at any point is 7% of issued and outstanding shares. The RSU plan permits the maximum number of shares that may be reserved for issuance is fixed at 1,500,000.

During the three months ended December 31, 2016, 413,500 options (December 31, 2015 - 30,000) and 489,000 RSUs (December 31, 2015 - nil) were granted.

The common shares, options, and RSUs outstanding and exercisable as at the following dates are:

	December 31, 2016		September 30, 2016	
	Number	Weighted average exercise price	Number	Weighted average exercise price
Common shares outstanding	53,886,285		53,864,285	
Options				
Outstanding	2,795,000	\$ 1.30	2,488,500	\$ 1.29
Exercisable	1,988,500	\$ 1.35	1,954,625	\$ 1.35
RSUs				
Outstanding	940,030	N/A	451,030	N/A

As at February 24, 2017 the Company has 54,136,285 common shares issued and outstanding. There are no preferred shares issued and outstanding.

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## ADDITIONAL INFORMATION

### Outlook

Nanotech is a leader in next-generation anti-counterfeiting products. These products have brand protection and enhancement applications across a wide range of markets including banknotes, secure government documents, commercial branding, and the pharmaceutical industry. Nanotech is initially focusing its efforts on the banknote market due to its high margins and established customer base. Management continues to believe that the Company is well positioned to supply its Asian customer, however the additional time required for product acceptance and integration into their production processes has taken longer than anticipated. Upon completion of the fine tuning of the OTF process by our production partner Hueck Folien, Nanotech will be well positioned to deliver OTF to meet our Asian customer's banknote needs. The Company is focusing on further developing business with its established customer base and as a result, is well positioned to expand its authentication development contract revenue and other Optic and OTF opportunities in the years ahead.

Management has established a goal to double its revenue and make significant progress towards becoming cash flow positive. Achieving these results is not certain and involves known and unknown risks that may cause actual results to differ materially from this goal. These risks and uncertainties include, among other things, risks related to: uncertainty of amount and timing of purchase orders, the ability of Hueck Folien to successfully deliver to our Asian customer, our ability to expand our Optics development revenue and our ability to maintain sufficient liquidity through December 31, 2017 to facilitate any business ramp-up. These and other risk factors are further discussed under the "Business Risks and Uncertainties" segment of the September 30, 2016 MD&A.

### Public Securities Filings

Additional information about Nanotech, is available on the Company's website at [www.nanosecurity.ca](http://www.nanosecurity.ca), or on SEDAR at [www.sedar.com](http://www.sedar.com).

Condensed Consolidated Interim Financial Statements of

**Nanotech Security Corp.**

Three months ended December 31, 2016 and 2015  
(Unaudited)

# Nanotech Security Corp.

Condensed Consolidated Statements of Operations and Comprehensive Loss  
(Unaudited)

Three months ended December 31, 2016 and 2015  
(In Canadian dollars)

	2016	2015
Revenue	\$ 907,013	\$ 1,509,240
Cost of sales	275,737	760,820
Gross profit	631,276	748,420
Expenses (note 10)		
Research and development	445,081	558,197
General and administration	656,577	647,689
Sales and marketing	472,903	548,776
Depreciation and amortization	724,034	770,157
	2,298,595	2,524,819
Loss before other expenses (income)	(1,667,319)	(1,776,399)
Other expenses (income)		
Foreign exchange gain	(44,394)	(66,483)
Finance expense	231,969	36,419
Gain on disposal of asset	(1,614)	-
	185,961	(30,064)
Net loss	(1,853,280)	(1,746,335)
Other comprehensive loss:		
Items that may be subsequently reclassified to earnings:		
Unrealized foreign exchange loss on translation of foreign operation	(24,969)	(28,114)
Total comprehensive loss for the period	\$ (1,878,249)	\$ (1,774,449)
Loss per share		
Basic and diluted	\$ (0.03)	\$ (0.03)
Weighted average number of common shares		
Basic and diluted	53,871,231	53,387,215

See accompanying notes to Condensed Consolidated Interim Financial Statements.

# Nanotech Security Corp.

Condensed Consolidated Statements of Financial Position  
(Unaudited)

(In Canadian dollars)

	December 31, 2016	September 30, 2016
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 2,306,141	\$ 3,312,691
Accounts receivable	678,902	597,414
Inventory (note 3)	478,984	385,753
Prepaid expenses and other assets	90,840	127,719
	<u>3,554,867</u>	<u>4,423,577</u>
Property, plant and equipment	16,964,278	17,338,312
Intangible assets	1,020,929	1,361,239
Goodwill	1,388,458	1,388,458
	<u>\$ 22,928,532</u>	<u>\$ 24,511,586</u>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued liabilities	\$ 1,394,681	\$ 1,395,568
Note payable (note 4)	3,000,000	3,000,000
	<u>4,394,681</u>	<u>4,395,568</u>
<b>Non-current liabilities:</b>		
Convertible debentures (note 5)	3,671,166	3,595,142
Tenant inducement	91,900	98,793
	<u>8,157,747</u>	<u>8,089,503</u>
<b>Shareholders' equity</b>		
Share capital (note 6)	45,241,016	45,210,507
Share based payment reserve	2,238,398	2,041,956
Equity component of convertible debentures (note 5)	443,175	443,175
Deficit	(32,972,325)	(31,119,045)
Accumulated other comprehensive loss	(179,479)	(154,510)
	<u>14,770,785</u>	<u>16,422,083</u>
	<u>\$ 22,928,532</u>	<u>\$ 24,511,586</u>

Nature of operations and going concern (note 1(b)).

Related party transactions (note 7).

See accompanying notes to Condensed Consolidated Interim Financial Statements.

Approved on behalf of the Board of Directors:

"Doug Blakeway"

Doug Blakeway, Director

"Ken Tolmie"

Ken Tolmie, Director

## Nanotech Security Corp.

Condensed Consolidated Statements of Changes in Equity  
(Unaudited)

Three months ended December 31, 2016 and 2015  
(In Canadian dollars)

	Number of shares	Share capital	Share based payment reserve	Equity component of convertible debentures	Deficit	Accumulated other comprehensive loss	Total shareholders' equity
<b>Balance as at October 1, 2015</b>	53,387,215	\$ 44,666,497	\$ 1,726,780	\$ -	\$ (23,289,240)	\$ (179,164)	\$ 22,924,873
Net loss	-	-	-	-	(1,746,335)	-	(1,746,335)
Unrealized foreign exchange loss on translation	-	-	-	-	-	(28,114)	(28,114)
Share based payments (note 6(b) and (c))	-	-	75,421	-	-	-	75,421
<b>Balance as at December 31, 2015</b>	53,387,215	\$ 44,666,497	\$ 1,802,201	\$ -	\$ (25,035,575)	\$ (207,278)	\$ 21,225,845
<b>Balance as at October 1, 2016</b>	53,864,285	\$ 45,210,507	\$ 2,041,956	\$ 443,175	\$ (31,119,045)	\$ (154,510)	\$ 16,422,083
Net loss	-	-	-	-	(1,853,280)	-	(1,853,280)
Unrealized foreign exchange loss on translation	-	-	-	-	-	(24,969)	(24,969)
Share based payments (note 6(b) and (c))	-	-	203,951	-	-	-	203,951
Options exercised (note 6(b))	22,000	30,509	(7,509)	-	-	-	23,000
<b>Balance as at December 31, 2016</b>	53,886,285	\$ 45,241,016	\$ 2,238,398	\$ 443,175	\$ (32,972,325)	\$ (179,479)	\$ 14,770,785

See accompanying notes to Condensed Consolidated Interim Financial Statements.

# Nanotech Security Corp.

Condensed Consolidated Statements of Cash Flows  
(Unaudited)

Three months ended December 31, 2016 and 2015  
(In Canadian dollars)

	2016	2015
Cash flows provided by (used in):		
Operating activities:		
Net loss	\$ (1,853,280)	\$ (1,746,335)
Items not involving cash:		
Depreciation and amortization	731,305	773,495
Share-based compensation	203,951	75,421
Amortization of tenant inducement	(6,893)	(6,893)
Gain on disposal of asset	(1,614)	-
Accretion of convertible debentures	76,024	-
Non-cash working capital changes (note 8(a))	(138,727)	(283,264)
Cash used in operating activities	(989,234)	(1,187,576)
Investing activities:		
Purchase of property and equipment, net of disposal	(14,619)	(168,434)
Cash used in investing activities	(14,619)	(168,434)
Financing activities:		
Issuance of shares for options exercised	23,000	-
Cash provided by financing activities	23,000	-
Effect of foreign exchange on cash and cash equivalents	(25,697)	(29,586)
Decrease in cash and cash equivalents	(1,006,550)	(1,385,596)
Cash and cash equivalents, beginning of period	3,312,691	3,021,928
Cash and cash equivalents, end of period	\$ 2,306,141	\$ 1,636,332

See supplementary cash flow information (note 8).

See accompanying notes to Condensed Consolidated Interim Financial Statements.

# Nanotech Security Corp.

Notes to the Condensed Consolidated Interim Financial Statements  
(Unaudited)

Three months ended December 31, 2016 and 2015  
(In Canadian dollars)

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## 1. Summary of business and nature of operations and going concern:

### (a) *Summary of business:*

Nanotech Security Corp. (the "Company" or "Nanotech") is incorporated under the laws of British Columbia with common shares listed on the TSX Venture Exchange (trading symbol: NTS) and quoted in the United States on the OTCQX Market (trading symbol: NTSFF). The Company's head office is located at #505 - 3292 Production Way, Burnaby, British Columbia, Canada V5A 4R4.

Nanotech is a global optics company, focusing on light based recognition nano-optics and optical thin film ("OTF") for use in authentication and brand enhancement products including currency, legal documents, and commercial products. Its wholly-owned subsidiary, Tactical Technologies Inc. ("TTI"), designs and sells a wide range of sophisticated surveillance and officer protection equipment for the law enforcement and defense industries primarily in the United States and Canada.

### (b) *Nature of operations and going concern:*

These condensed consolidated interim financial statements have been prepared on the basis that the Company will continue as a going concern. The Company has recurring operating losses and an accumulated deficit of \$32,972,325 as of December 31, 2016. The Company expects to continue to incur substantial expenses relating to its research and development efforts in nano-optics and OTF. As a result, the Company may incur losses in the next few years until it is able to realize additional revenues. The timing and amount of such revenues, if any, cannot be predicted with certainty.

The Company's ability to continue as a going concern is dependent on its ability to generate positive cash flows or additional financing in order to meet its planned business objectives and to be able to commercialize future products currently in development. The Company may need to raise funds through grants, strategic collaborations, public or private equity, debt financing, or other funding sources. This funding may not be available, or be available on acceptable terms, and may be dilutive to shareholder interests. If the Company is unable to generate positive cash flows from operations or obtain adequate financing, the Company may need to curtail operations and development activities. These factors cast significant doubt on the Company's ability to continue as a going concern. Should the Company be unable to realize its assets and discharge its liabilities in the normal course of business, the net realizable value of its assets may be materially less than the amounts on the condensed consolidated statement of financial position.

## 2. Basis of preparation:

### (a) *Statement of compliance:*

These condensed consolidated interim financial statements are prepared in accordance with International Accounting Standards ("IAS") 34, Interim Financial Reporting, as issued by the International Accounting Standards board ("IASB") on a basis consistent with those followed in the most recent annual consolidated financial statements.

These condensed consolidated interim financial statements do not include all of the information required for full annual financial statements and were approved and authorized for issue by the Company's Board of Directors on February 24, 2017.



# Nanotech Security Corp.

Notes to the Condensed Consolidated Interim Financial Statements  
(Unaudited)

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## 2. Basis of preparation (continued):

### (a) *Statement of compliance (continued):*

These condensed consolidated interim financial statements should be read in conjunction with the Company's consolidated financial statements for the year ended September 30, 2016.

Certain comparative figures in the consolidated statements of operations and comprehensive loss have been reclassified to conform to the current period's presentation. This reclassification had no impact on the net loss or total comprehensive loss.

### (b) *Basis of measurement:*

These condensed consolidated interim financial statements are presented in Canadian dollars and have been prepared on a historical cost basis, except for certain financial instruments which are measured at fair value.

## 3. Inventory:

	December 31, 2016	September 30, 2016
Raw materials	\$ 269,512	\$ 309,055
Work in progress	199,079	76,698
Finished goods	10,393	-
	<u>\$ 478,984</u>	<u>\$ 385,753</u>

During the three months ended December 31, 2016, the write-down of inventories to net realizable value amounted to \$nil (December 31, 2015 - \$nil).

For the three months ended December 31, 2016, the Company recognized inventories of \$106,350 (December 31, 2015 - \$483,077) as expensed through cost of sales.

## 4. Note payable:

The note payable is fully secured against the assets of the Company. It bears interest at a fixed rate of 4% per annum and is repayable in interest only with payment of the principal due on September 16, 2017.

## 5. Convertible debentures:

On June 9, 2016, the Company completed an initial tranche of a non-brokered private placement of unsecured subordinated convertible debentures in the amount of \$2,505,000, with a second and final tranche closing on June 21, 2016 in the amount of \$1,680,000 for total gross proceeds of \$4,185,000, which will be repaid upon maturity on May 31, 2018.

The convertible debentures accrue interest at a rate of 12% per annum payable quarterly in arrears and are convertible into common shares of the Company at a price of \$1.25 per share. The debentures are convertible into shares at the Company's option, at a price equal to their principal amount provided that the Company's common shares trade and close on the TSXV at or above \$2.00 for ten consecutive days any time after four months from issuance.

The convertible debentures are compound financial instruments and the gross proceeds at the issuance date are allocated between each component of the instrument, first based on fair value of liability and the residual to equity. Transaction costs related to the issuance in the amount of \$64,711 are allocated proportionately and each of the components are recorded in the financial statements net of allocated transaction costs. The Company identified three components; a debt-host instrument, an

# Nanotech Security Corp.

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## 5. Convertible debentures (continued):

equity conversion option encompassing the holder's option, and the Company's embedded call option.

The Company determined that on the date of issuance, the fair value of the debt-host instrument determined with reference to market interest rates and credit spreads for similar debt without the equity conversion options was \$3,569,511. The embedded call option was determined to have a fair value of \$nil at the issuance date. The remaining value of \$615,489 was allocated to the equity conversion option (net of allocated issuance costs) as prescribed under International Financial Reporting Standards ("IFRS").

	Convertible debentures	Equity component of convertible debentures	Total
Gross proceeds on issuance	\$ 3,569,511	\$ 615,489	\$ 4,185,000
Transaction costs	(55,194)	(9,517)	(64,711)
Net proceeds on issuance	3,514,317	605,972	4,120,289
Deferred tax liability	-	(162,797)	(162,797)
Interest expense	233,352	-	233,352
Interest paid	(152,527)	-	(152,527)
Balance as at September 30, 2016	3,595,142	443,175	4,038,317
Interest expense	202,606	-	202,606
Interest paid	(126,582)	-	(126,582)
Balance as at December 31, 2016	\$ 3,671,166	\$ 443,175	\$ 4,114,341

The effective interest rate applied to accrete the carrying value of the debt-host instrument to the redemption value upon maturity is approximately 22.3%.

At December 31, 2016 the convertible debentures had a fair value of approximately \$3,800,000.

## 6. Share capital:

### (a) Share capital:

Authorized:

Unlimited number of common shares with no par value  
Unlimited number of preferred shares with no par value

Common shares issued and fully paid:

	Number of shares	Amount
Balance as at September 30, 2016	53,864,285	\$ 45,210,507
Options exercised	22,000	30,509
Balance as at December 31, 2016	53,886,285	\$ 45,241,016

There are no preferred shares issued and outstanding.

# Nanotech Security Corp.

Notes to the Condensed Consolidated Interim Financial Statements  
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## 6. Share capital (continued):

### (b) Stock option plan:

Stock options outstanding as at December 31, 2016 are:

	Number of options	Weighted average exercise price
Balance, September 30, 2016	2,488,500	\$ 1.29
Granted	413,500	1.48
Exercised	(22,000)	1.05
Forfeited	(85,000)	1.75
Balance, December 31, 2016	2,795,000	\$ 1.30

The following table summarizes information pertaining to the Company's stock options outstanding as at December 31, 2016:

Range of exercise prices	Options outstanding			Options exercisable	
	Number of options outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
\$0 - \$1.00	250,000	0.00	\$ 0.80	250,000	\$ 0.80
\$1.01 - \$1.65	2,545,000	3.57	1.35	1,738,500	1.40
	2,795,000	3.25	\$ 1.30	1,988,500	\$ 1.35

The original term of the 250,000 stock options expired on September 30, 2016 and the term had been extended until a date still to be determined.

The exercise price of all stock options granted during the period are equal to the closing market price at the grant date. The Company calculates the fair value of the options at the grant date using the Black-Scholes option-pricing model with assumptions noted below.

The weighted average assumptions used to estimate the fair value of options granted during the three month periods ended December 31, 2016 and 2015:

	Three months ended December 31,	
	2016	2015
Risk free interest rate	1.21%	0.52%
Expected life	4.4	1.7
Vesting period	1.5 years	0.3 years
Expected volatility	46%	45%
Expected dividends	Nil	Nil
Average fair value	\$0.58	\$0.28
Forfeiture rate	11.4%	10.2%

# Nanotech Security Corp.

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## 6. Share capital (continued):

### (b) Stock option plan (continued):

The Company charged the following share-based payments to expenses in connection with the Company's stock option plan, with a corresponding increase in the share-based payment reserve:

	Three months ended December 31,	
	2016	2015
Total compensation - stock options	\$ 135,343	\$ 43,453

### (c) Restricted share unit plan:

During the quarter ended December 31, 2016, the Company granted 489,000 restricted share units ("RSUs") to employees and directors with a fair value of \$1.48 per share. 25% of these RSUs will vest on September 1, 2017, 35% will vest on September 1, 2018, and the remaining 40% will vest on September 1, 2019.

RSUs outstanding as at December 31, 2016 are:

	Number of RSUs
Balance as at September 30, 2016	451,030
Granted	489,000
Balance as at December 31, 2016	940,030

Using an estimated forfeiture rate of 10% for the three months ended December 31, 2016 and 2015, the Company charged the following share-based payments to operating expenses in connection with the Company's RSU plan, with a corresponding increase in the share-based payment reserve:

	Three months ended December 31,	
	2016	2015
Total compensation - RSUs	\$ 68,608	\$ 31,968

### (d) Warrants:

Warrants outstanding as at December 31, 2016 are:

	Number of warrants	Weighted average exercise price
Balance as at September 30, 2016 and December 31, 2016	1,327,500	\$ 1.50

The remaining warrants expire on February 26, 2017.

# Nanotech Security Corp.

Notes to the Condensed Consolidated Interim Financial Statements  
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## 7. Related party transactions:

(a) The remuneration of key management personnel:

	Three months ended December 31,	
	2016	2015
Salaries, accrued bonuses, and employee benefits	\$ 223,365	\$ 300,704
Share-based payments	147,787	56,070
	<u>\$ 371,152</u>	<u>\$ 356,774</u>

(b) Management fees and accrued bonuses totaling \$79,800 for the three months ended December 31, 2016 (December 31, 2015 - \$121,500) by a company controlled by an officer and director of the Company, were included in salaries and benefits expense. As of December 31, 2016, amounts owing to this company included in accounts payable and accrued liabilities were \$333,751 (September 30, 2016 - \$285,509).

(c) Legal and professional fees, taxes and disbursements totaling \$34,553 for the three months ended December 31, 2016 (December 31, 2015 - \$21,486) were incurred with a law firm of which a director of the Company is a partner. As of December 31, 2016, amounts owing to this company included in accounts payable and accrued liabilities were \$58,718 (September 30, 2016 - \$52,826).

The above transactions are in the normal course of business and are measured at the exchange amount which is the amount of consideration established and agreed to by the related parties.

## 8. Supplementary cash flow information:

(a) *Change in non-cash working capital:*

	Three months ended December 31,	
	2016	2015
Accounts receivable	\$ (81,488)	\$ (75,850)
Inventory	(93,231)	174,914
Prepaid expenses and other assets	36,879	(9,071)
Accounts payable and accrued liabilities	(887)	(412,653)
Deferred revenue	-	39,396
	<u>\$ (138,727)</u>	<u>\$ (283,264)</u>

(b) *Interest and income taxes:*

During the three months ended December 31, 2016, the Company paid \$156,595 in interest (December 31, 2015 - \$32,000). The Company did not pay any income taxes during the three months ended December 31, 2016 and 2015.

(c) *Cash and cash equivalents:*

Cash and cash equivalents are comprised of:

	December 31, 2016	September 30, 2016
Cash	\$ 734,031	\$ 644,490
Term deposit	1,572,110	2,668,201
	<u>\$ 2,306,141</u>	<u>\$ 3,312,691</u>

# Nanotech Security Corp.

Notes to the Condensed Consolidated Interim Financial Statements  
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(In Canadian dollars)

## 9. Segmented information:

Segmented information is prepared using the accounting policies described in note 16 of the Company's consolidated financial statements for the year ended September 30, 2016. The Company's business operates primarily through two business segments - Optics and Tactical. Optics provides nano-optics and OTF for use in authentication and brand enhancement products including currency, legal documents, and commercial products. Tactical designs and sells sophisticated surveillance and officer protection equipment for the law enforcement and defense industries in the United States and Canada.

During the three months ended December 31, 2016, the Company had one customer who represented greater than 10% of total revenues. This customer from our Optics segment represented approximately 70% of total revenues (December 31, 2015 - two customers represented approximately 28% from our Optics segment and 37% from our Tactical segment).

December 31, 2016	Optics	Tactical	Total
Total current assets	\$ 3,171,176	\$ 383,691	\$ 3,554,867
Property, plant and equipment	16,935,134	29,144	16,964,278
Intangible assets	1,020,929	-	1,020,929
Goodwill	1,388,458	-	1,388,458
Total current liabilities	4,329,294	65,387	4,394,681
Total liabilities	8,092,360	65,387	8,157,747

September 30, 2016	Optics	Tactical	Total
Total current assets	\$ 3,920,822	\$ 502,755	\$ 4,423,577
Property, plant and equipment	17,306,698	31,614	17,338,312
Intangible assets	1,361,239	-	1,361,239
Goodwill	1,388,458	-	1,388,458
Total current liabilities	4,319,162	76,406	4,395,568
Total liabilities	8,013,097	76,406	8,089,503

Three months ended December 31, 2016	Optics	Tactical	Total
Revenue	\$ 694,471	\$ 212,542	\$ 907,013
Cost of sales	116,469	159,268	275,737
Gross profit	578,002	53,274	631,276
Expenses	2,064,038	234,557	2,298,595
Other expenses (income)	186,725	(764)	185,961
Net loss	\$ (1,672,761)	\$ (180,519)	\$ (1,853,280)

Three months ended December 31, 2015	Optics	Tactical	Total
Revenue	\$ 569,467	\$ 939,773	\$ 1,509,240
Cost of sales	146,762	614,058	760,820
Gross profit	422,705	325,715	748,420
Expenses	2,292,495	232,324	2,524,819
Other expenses (income)	(33,002)	2,938	(30,064)
Net income (loss)	\$ (1,836,788)	\$ 90,453	\$ (1,746,335)

# Nanotech Security Corp.

Notes to the Condensed Consolidated Interim Financial Statements  
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## 10. Nature of expenses:

The expenses presented below represent total cost of sales, sales and marketing, research and development, general and administrative expenses, and amortization and depreciation.

	Three months ended December 31,	
	2016	2015
Salaries and benefits	\$ 847,560	\$ 989,897
Share-based compensation	203,951	75,421
Depreciation and amortization	729,701	773,495
Travel and entertainment	66,663	107,380
Professional fees, legal, and insurance	175,399	229,086
Public company costs	173,300	174,772
Rent and utilities	116,182	184,759
Repairs and maintenance and office expenses	71,129	70,699
Materials consumed	190,447	680,130
	<u>\$ 2,574,332</u>	<u>\$ 3,285,639</u>

At December 31, 2016, depreciation of \$1,604 (December 31, 2015 - \$nil) and salaries and benefits of \$98,795 (December 31, 2015 - \$14,170) have been included in inventory. Salaries and benefits of \$nil were capitalized to equipment at December 31, 2016 (December 31, 2015 - \$130,918).