Quarterly Report

March 31, 2017

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 March 31, 2017.

ADVISORY

This MD&A dated as of May 25, 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 and six months ended March 31, 2017 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.

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. 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 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 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.

RESULTS OF OPERATIONS

Select financial information for the three and six months ended March 31, 2017 and 2016:

Select Financial Information

	Three months ended March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Revenue	$ 1,763,600	$ 948,220	$ 2,670,613	$ 2,457,460
Cost of sales	712,788	455,218	988,525	1,216,038
	1,050,812	493,002	1,682,088	1,241,422
Expenses				
Research and development	460,580	667,189	905,661	1,225,386
General and administration	759,919	678,393	1,416,496	1,326,082
Sales and marketing	577,906	653,105	1,050,809	1,201,881
Depreciation and amortization	696,359	771,081	1,420,393	1,541,238
	2,494,764	2,769,768	4,793,359	5,294,587
Loss before other expenses	(1,443,952)	(2,276,766)	(3,111,271)	(4,053,165)
Other expenses (income)	250,938	173,244	436,899	143,180
Net loss	$ (1,694,890)	$ (2,450,010)	$ (3,548,170)	$ (4,196,345)

Revenue

Consolidated revenues for the three months ended March 31, 2017 increased by $815,380 or 86% to $1,763,600 compared to $948,220 in the same period last year. Optics revenue increased by $773,695 or 120% to $1,418,644 compared to $644,949 last year primarily due to increased revenue from paid development contracts. Tactical's revenue increased by $41,685 or 14% to $344,956 compared to $303,271 in the previous year due to slightly higher equipment sales.

Customer paid development revenues continue to grow, and the projects are progressing well, as we continue to advance our optic based technologies into the development of new security features for future banknotes. The Company also continues to make progress with a specific Asian customer to finalize the product specifications and integrate our OTF into the customer's production facility. Management continues to expect our production partner to demonstrate their ability to produce OTF that meets the customer expectation later in 2017. In addition, management is beginning to see new OTF opportunities and is working with several new partners to expand our customer base to provide further growth.

Consolidated revenues for the six months ended March 31, 2017 increased by $213,153 or 9% to $2,670,613 compared to $2,457,460 in the same period last year. Optics revenue increased by $898,699 or 74% to $2,113,115 compared to $1,214,416 last year primarily due to increased revenue from paid development contracts. Tactical's revenue was lower by $685,546 which is a result of a large delivery of surveillance vans in the first quarter of the previous year which did not occur in the current year. 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 March 31, 2017 increased by $557,810 or 113% to $1,050,812 compared to $493,002 in the same period last year. Overall, the gross margin percentage improved to 60% for the three months ended March 31, 2017, an increase from 52% in the same period last year. The increased gross margins reflect the new high margin development revenue and the continued overall strong margins in the Optics division.

Gross margin for the six months ended March 31, 2017 increased by $440,666 or 35% to $1,682,088 compared to $1,241,422 in the same period last year. Overall, the gross margin percentage improved to

63% for the six months ended March 31, 2017, an increase from 51% in the same period last year. The increased gross margins continue to reflect strong margins in the Optics division.

Research and Development

Research and development expenditures for the three months ended March 31, 2017 decreased by $206,609 or 31% to $460,580 compared to $667,189 in the same period last year due to a larger portion of salaries and other expenses being allocated to cost of sales as a result of increased development revenue.

Research and development expenditures for the six months ended March 31, 2017 decreased by $319,725 or 26% to $905,661 compared to $1,225,386 in the same period last year again due to a larger portion of salaries and other expenses being allocated to cost of sales as a result of increased development contracts.

General and Administration

General and administration expenditures for the three months ended March 31, 2017 were $759,919, an increase of $81,526 or 12% compared to $678,393 in the same period last year which reflects an increase in stock based compensation and higher utilities costs at our Thurso production facility.

General and administration expenditures for the six months ended March 31, 2017 were $1,416,496, an increase of $90,414 or 7% compared to $1,326,082 in the same period last year which again reflects an increase in stock based compensation and higher utilities costs at our Thurso production facility.

Sales and Marketing

Sales and marketing expenditures for the three months ended March 31, 2017 were $577,906, a decrease of $75,199 or 12% compared to $653,105 in the same period last year. The decrease mainly relates to a reduction in travel and marketing expenses in the Optics division along with lower sales salaries in the Tactical division.

Sales and marketing expenditures for the six months ended March 31, 2017 were $1,050,809, a decrease of $151,072 or 13% compared to $1,201,881 in the same period last year. The decrease again mainly relates to a reduction in travel and marketing expenses in the Optics division along with lower sales salaries in the Tactical division.

Depreciation and Amortization

Depreciation and amortization expenditures for the three months ended March 31, 2017 were $696,359, compared to $771,081 in the same period last year, reflecting declining balance depreciation and fewer fixed asset additions in the current period.

Depreciation and amortization expenditures for the six months ended March 31, 2017 were $1,420,393, compared to $1,541,238 in the same period last year, again reflecting declining balance depreciation and fewer fixed asset additions in the current period.

Other Expenses

Other expenses for the three months ended March 31, 2017 were $250,938 an increase of $77,694 compared to $173,244 in the same period last year. The increase mainly relates to the interest on the convertible debentures, offset by reduced foreign exchange loss in the current period.

Other expenses for the six months ended March 31, 2017 were $436,899 an increase of $293,719 compared to $143,180 in the same period last year. The increase mainly relates to the interest on the convertible debentures and foreign exchange gain in the current period.

Net Loss

The net loss for the three months ended March 31, 2017 was $1,694,890 compared to $2,450,010 during the same period last year. The decrease in net loss reflects an increase in revenues, reduced expenses and higher margins.

The net loss for the six months ended March 31, 2017 was $3,548,170 compared to $4,196,345 during the same period last year. The decrease in net loss also reflects an increase in revenues, reduced expenses and higher margins.

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.

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 March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Revenue	$ 1,418,644	$ 644,949	$ 2,113,115	$ 1,214,416
Net loss	(1,558,880)	(2,279,893)	(3,231,641)	(4,116,681)

Revenues from Optics for the three months ended March 31, 2017 increased to $1,418,644 from $644,949 for the same period last year. The increased revenue was primarily due to increased paid development contracts revenue.

The loss from Optics for the three months ended March 31, 2017 improved by $721,013 to $1,558,880 from $2,279,893 for the same period last year. The decrease in net loss reflects increased sales, partially offset by increased financing costs.

Revenues from Optics for the six months ended March 31, 2017 increased to $2,113,115 from $1,214,416 for the same period last year. The increased revenue was primarily due to increased paid development contracts revenue.

The loss from Optics for the six months ended March 31, 2017 improved by $885,040 to $3,231,641 from $4,116,681 for the same period last year. The decrease in net loss reflects increased sales, and reduced expenses, 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 March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Revenue	$ 344,956	$ 303,271	$ 557,498	$ 1,243,044
Net income (loss)	(136,010)	(170,117)	(316,529)	(79,664)

Revenues from Tactical for the three months ended March 31, 2017 increased to $344,956 from $303,271 which is consistent with the same period last year.

The net loss from Tactical for the three months ended March 31, 2017 decreased to $136,010 from a net loss of $170,117 in the same period last year. The net loss was the result of decreased expenses during the quarter, mostly related to sales expenses.

Revenues from Tactical for the six months ended March 31, 2017 decreased to $557,498 from $1,243,044 in the same period last year. This decrease reflects the large delivery of surveillance vans in the in the first half of last year, which did not occur in the current year. 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 six months ended March 31, 2017 increased to $316,529 from a net loss of $79,664 in the same period last year. The net loss was the result of decreased sales in the current period.

QUARTERLY RESULTS

	Q2 2017	Q1 2017	Q4 2016	Q3 2016	Q2 2016	Q1 2016	Q4 2015	Q3 2015
($ thousands, except common share amounts)								
Revenue	$1,764	$ 907	$1,511	$1,158	$ 948	$1,509	$ 728	$1,359
Net loss	(1,695)	(1,853)	(1,677)	(1,957)	(2,450)	(1,746)	(1,565)	(1,280)
Net loss per common share:								
Basic	(0.03)	(0.03)	(0.03)	(0.04)	(0.05)	(0.03)	(0.03)	(0.03)
Diluted	(0.03)	(0.03)	(0.03)	(0.04)	(0.05)	(0.03)	(0.03)	(0.03)

There are no seasonal effects or other trends in the Company's business over the quarters presented.

RELATED PARTY TRANSACTIONS

For the three and six months ended March 31, 2017, 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 March 31, 2017	Three months ended March 31, 2016	Six months ended March 31, 2017	Six months ended March 31, 2016
Salaries, accrued bonuses, and employee benefits	$ 247,556	$ 261,840	$ 470,922	$ 562,544
Share-based payments	249,748	185,243	397,535	241,369
	$ 497,304	$ 447,083	$ 868,457	$ 803,913

(b) As of March 31, 2017, amounts owing to a company controlled by an officer and director of the Company included in accounts payable and accrued liabilities were $313,709 (September 30, 2016 - $285,509).

(c) Legal and professional fees, taxes and disbursements totaling $27,001 for the three months ended March 31, 2017 (March 31, 2016 - $43,591) and $61,554 for the six months ended March 31, 2017 (March 31, 2016 - $65,077) were incurred with a law firm of which a director of the Company is a partner. As of March 31, 2017, amounts owing to this company included in accounts payable and accrued liabilities were $86,760 (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 customer receivables, inventory, supplier payables, capital expenditures, and fixed overhead costs. Cash is also used to finance other long-term strategic business initiatives.

Summary of Statements of Cash Flows

	Three months ended March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Cash used in operating activities[1]	$ (579,030)	$(1,436,779)	$(1,431,141)	$(2,341,091)
Changes in operating assets and liabilities	(472,813)	738,939	(609,936)	455,675
Cash used in operating activities	(1,051,843)	(697,840)	(2,041,077)	(1,885,416)
Cash used in investing activities	(73,946)	(40,435)	(88,565)	(208,869)
Cash provided by financing activities	200,000	180,000	223,000	180,000
Effect of foreign exchange on cash and cash equivalents	11,162	63,683	(14,535)	34,097
Cash and cash equivalents, beginning of period	2,306,141	1,636,332	3,312,691	3,021,928
Cash and cash equivalents, end of period	$ 1,391,514	$ 1,141,740	$ 1,391,514	$ 1,141,740

[1] Before changes in operating assets and liabilities

Operating Activities

Cash used in operating activities was $1,051,843 for the three months ended March 31, 2017, compared to $697,840 for the same period last year. This increase was as a result of a significant improvement in operating cash burn offset by a working capital increase as development contract revenue remained uncollected at quarter end.

Cash used in operating activities was $2,041,077 for the six months ended March 31, 2017, compared to $1,885,416 for the same period last year. This increase was as a result of a significant improvement in operating cash burn offset by a working capital increase as development contract revenue remained uncollected at quarter end.

Investing Activities

Cash used in investing activities was $73,946 for the three months ended March 31, 2017, which is consistent with $40,435 used in the same period last year.

Cash used in investing activities was $88,565 for the six months ended March 31, 2017, compared to $208,869 used in the same period last year. This reflects reduced expenditures on production equipment in the current period as our production equipment upgrades were concluded early in the previous year.

Financing Activities

Cash provided by financing activities was $200,000 for the three months ended March 31, 2017, compared to $180,000 during the same period last year. This reflects proceeds on the exercise of stock options during both periods.

Cash provided by financing activities was $223,000 for the six months ended March 31, 2017, compared to $180,000 during the same period last year. This reflects the proceeds on the exercise of stock options during both periods.

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 $34,667,215 as of March 31, 2017. 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 six months ended March 31, 2017, there were no changes in our approach to capital management.

As at March 31, 2017 cash and cash equivalents amounted to $1,391,514, compared to $3,312,691 as at September 30, 2016. Subsequent to the quarter end, on May 18, 2017, the Company has completed a bought deal private placement with a syndicate of underwriters whereby a total of 11,586,870 common shares of the Company have been issued and sold, at a price per share of $1.15, for total gross proceeds of $13,324,900.

The Company has a note payable outstanding of $3,000,000 as at March 31, 2017. 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 March 31, 2017 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 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 has the option to pre-pay the principal sum, in whole or in part, twelve months following the closing, after providing twenty business days' notice to the holder.

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

The Company had no commitments for material capital expenditures as of March 31, 2017.

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 March 31, 2018.

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 and six months ended March 31, 2017, 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. As at March 31, 2017 the shareholders have approved that the Company has the right to grant up to an additional 816,369 RSUs.

During the three months ended March 31, 2017, nil options (March 31, 2016 - 416,500) and nil RSUs (March 31, 2016 – 387,900) were granted. During the six months ended March 31, 2017, 413,500 options (March 31, 2016 - 446,500) and 489,000 RSUs (March 31, 2016 – 387,900) were granted. Of the 413,500 options granted during the six months ended March 31, 2017, 150,000 were forfeited during the quarter.

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

	March 31, 2017		September 30, 2016	
	Number	Weighted average exercise price	Number	Weighted average exercise price
Common shares outstanding	54,136,285		53,864,285	
Options				
Outstanding	2,040,000	$ 1.35	2,488,500	$ 1.29
Exercisable	1,543,875	$ 1.39	1,954,625	$ 1.35
RSUs				
Outstanding	940,030	N/A	451,030	N/A

As at May 25, 2017, the Company has 65,723,155 common shares issued and outstanding, reflecting the closing of the private placement for gross proceeds of $13,324,900. There are no preferred shares issued and outstanding.

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. With the recent signing of the $30 million paid development contract, 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.

In 2017, 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 March 31, 2018 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, or on SEDAR at www.sedar.com.

Condensed Consolidated Interim Financial Statements of

Nanotech Security Corp.

Three and six months ended March 31, 2017 and 2016
(Unaudited)

Nanotech Security Corp.

Condensed Consolidated Statements of Operations and Comprehensive Loss
(Unaudited)

Three and six months ended March 31, 2017 and 2016
(In Canadian dollars)

	Three months ended March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Revenue	$ 1,763,600	$ 948,220	$ 2,670,613	$ 2,457,460
Cost of sales (note 10)	712,788	455,218	988,525	1,216,038
Gross profit	1,050,812	493,002	1,682,088	1,241,422
Expenses (note 10)				
Research and development	460,580	667,189	905,661	1,225,386
General and administration	759,919	678,393	1,416,496	1,326,082
Sales and marketing	577,906	653,105	1,050,809	1,201,881
Depreciation and amortization	696,359	771,081	1,420,393	1,541,238
	2,494,764	2,769,768	4,793,359	5,294,587
Loss before other expenses	(1,443,952)	(2,276,766)	(3,111,271)	(4,053,165)
Other expenses (income)				
Foreign exchange (gain) loss	17,213	142,699	(27,181)	76,216
Finance expense	233,725	30,545	465,694	66,964
Gain on disposal of asset	-	-	(1,614)	-
	250,938	173,244	436,899	143,180
Net loss	(1,694,890)	(2,450,010)	(3,548,170)	(4,196,345)
Other comprehensive loss:				
Items that may be subsequently reclassified to earnings:				
Unrealized foreign exchange gain (loss) on translation of foreign operation	10,867	61,361	(14,102)	33,247
Total comprehensive loss for the period	$(1,684,023)	$(2,388,649)	$(3,562,272)	$(4,163,098)
Loss per share				
Basic and diluted	$ (0.03)	$ (0.05)	$ (0.07)	$ (0.08)
Weighted average number of common shares				
Basic and diluted	54,122,396	53,399,510	53,995,433	53,411,940

See accompanying notes to Condensed Consolidated Interim Financial Statements.

Nanotech Security Corp.

Condensed Consolidated Statements of Financial Position
(Unaudited)

(In Canadian dollars)

	March 31, 2017	September 30, 2016
Assets		
Current assets:		
Cash and cash equivalents	$ 1,391,514	$ 3,312,691
Accounts receivable	1,565,262	597,414
Inventory (note 3)	395,032	385,753
Prepaid expenses and other assets	107,041	127,719
	3,458,849	4,423,577
Property, plant and equipment	16,645,950	17,338,312
Intangible assets	680,619	1,361,239
Goodwill	1,388,458	1,388,458
	$ 22,173,876	$ 24,511,586
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 1,742,081	$ 1,395,568
Note payable (note 4)	3,000,000	3,000,000
	4,742,081	4,395,568
Non-current liabilities:		
Convertible debentures (note 5)	3,749,729	3,595,142
Tenant inducement	85,008	98,793
	8,576,818	8,089,503
Shareholders' equity		
Share capital (note 6)	45,556,794	45,210,507
Share-based payment reserve	2,432,916	2,041,956
Equity component of convertible debentures (note 5)	443,175	443,175
Deficit	(34,667,215)	(31,119,045)
Accumulated other comprehensive loss	(168,612)	(154,510)
	13,597,058	16,422,083
	$ 22,173,876	$ 24,511,586

Nature of operations and going concern (note 1(b)).
Related party transactions (note 7).
Subsequent event (note 11).
See accompanying notes to Condensed Consolidated Interim Financial Statements.

Approved on behalf of the Board of Directors:

"Doug Blakeway"	*"Ken Tolmie"*
Doug Blakeway, Director	Ken Tolmie, Director

Nanotech Security Corp.

Condensed Consolidated Statements of Changes in Equity
(Unaudited)

Six months ended March 31, 2017 and 2016
(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
Balance as at October 1, 2015	53,387,215	$ 44,666,497	$ 1,726,780	$ -	$ (23,289,240)	$ (179,164)	$ 22,924,873
Net loss	-	-	-	-	(4,196,345)	-	(4,196,345)
Unrealized foreign exchange loss on translation	-	-	-	-	-	33,247	33,247
Share-based payments (note 6(b) and (c))		-	320,970	-	-	-	320,970
Options exercised	225,000	263,936	(83,936)	-	-	-	180,000
Balance as at March 31, 2016	53,612,215	$ 44,930,433	$ 1,963,814	$ -	$ (27,485,585)	$ (145,917)	$ 19,262,745
Balance as at October 1, 2016	53,864,285	$ 45,210,507	$ 2,041,956	$ 443,175	$ (31,119,045)	$ (154,510)	$ 16,422,083
Net loss	-	-	-	-	(3,548,170)	-	(3,548,170)
Unrealized foreign exchange loss on translation	-	-	-	-	-	(14,102)	(14,102)
Share-based payments (note 6(b) and (c))	-	-	514,247	-	-	-	514,247
Options exercised (note 6(b))	272,000	346,287	(123,287)	-	-	-	223,000
Balance as at March 31, 2017	54,136,285	$ 45,556,794	$ 2,432,916	$ 443,175	$ (34,667,215)	$ (168,612)	$ 13,597,058

See accompanying notes to Condensed Consolidated Interim Financial Statements.

Nanotech Security Corp.

Condensed Consolidated Statements of Cash Flows
(Unaudited)

Three and six months ended March 31, 2017 and 2016
(In Canadian dollars)

	Three months ended March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Cash flows provided by (used in):				
Operating activities:				
Net loss	$(1,694,890)	$(2,450,010)	$(3,548,170)	$(4,196,345)
Items not involving cash:				
Depreciation and amortization	733,893	774,574	1,463,594	1,548,069
Share-based compensation	310,296	245,549	514,247	320,970
Amortization of tenant inducement	(6,892)	(6,892)	(13,785)	(13,785)
Gain on disposal of asset	-	-	(1,614)	-
Accretion of convertible debentures	78,563	-	154,587	-
Non-cash working capital changes (note 8(a))	(472,813)	738,939	(609,936)	455,675
Cash used in operating activities	(1,051,843)	(697,840)	(2,041,077)	(1,885,416)
Investing activities:				
Purchase of property and equipment, net of disposal	(73,946)	(40,435)	(88,565)	(208,869)
Cash used in investing activities	(73,946)	(40,435)	(88,565)	(208,869)
Financing activities:				
Issuance of shares for options exercised	200,000	180,000	223,000	180,000
Cash provided by financing activities	200,000	180,000	223,000	180,000
Effect of foreign exchange on cash and cash equivalents	11,162	63,683	(14,535)	34,097
Decrease in cash and cash equivalents	(914,627)	(494,592)	(1,921,177)	(1,880,188)
Cash and cash equivalents, beginning of period	2,306,141	1,636,332	3,312,691	3,021,928
Cash and cash equivalents, end of period	$ 1,391,514	$ 1,141,740	$ 1,391,514	$ 1,141,740

See supplementary cash flow information (note 8).
See accompanying notes to Condensed Consolidated Interim Financial Statements.

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 $34,667,215 as of March 31, 2017. 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 May 25, 2017.

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:

	March 31, 2017	September 30, 2016
Raw materials	$ 311,267	$ 309,055
Work in progress	83,765	76,698
	$ 395,032	$ 385,753

During the three and six months ended March 31, 2017, there were no write-downs of inventories to net realizable value (March 31, 2016 - $40,954).

For the three months ended March 31, 2017, the Company recognized inventories of $709,084 (March 31, 2016 - $451,818) as expensed through cost of sales. For the six months ended March 31, 2017, the Company recognized inventories of $980,670 (March 31, 2016 - $1,208,565) 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 Company has the option to pre-pay the principal sum, in whole or in part, twelve months following the closing, after providing twenty business days notice to the holder.

(In Canadian dollars)

5. Convertible debentures (continued):

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 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	404,999	-	404,999
Interest paid	(250,412)	-	(250,412)
Balance as at March 31, 2017	$ 3,749,729	$ 443,175	$ 4,192,904

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 March 31, 2017, the convertible debentures had a fair value of approximately $3,940,000.

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	272,000	346,287
Balance as at March 31, 2017	54,136,285	$ 45,556,794

There are no preferred shares issued and outstanding.

(In Canadian dollars)

6. Share capital (continued):

(b) *Stock option plan:*

Stock options outstanding as at March 31, 2017 are:

	Number of options	Weighted average exercise price
Balance, September 30, 2016	2,488,500	$ 1.29
Granted	413,500	1.48
Exercised	(272,000)	0.82
Forfeited	(590,000)	1.42
Balance, March 31, 2017	2,040,000	$ 1.35

The following table summarizes information pertaining to the Company's stock options outstanding as at March 31, 2017:

	Options outstanding			Options exercisable	
Range of exercise prices	Number of options outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
$1.01 - $1.65	2,040,000	3.29	$ 1.35	1,543,875	$ 1.39

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 and six month periods ended March 31, 2017 and 2016:

	Three months ended March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Risk free interest rate	Nil	0.66%	1.21%	0.65%
Expected life	Nil	4.4	4.4	4.1
Vesting period	Nil	1.6 years	1.5 years	1.5 years
Expected volatility	Nil	52%	46%	53%
Expected dividends	Nil	Nil	Nil	Nil
Average fair value	Nil	$0.54	$0.58	$0.52
Forfeiture rate	Nil	10.2%	11.4%	10.2%

(In Canadian dollars)

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 March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Total compensation - stock options	$ 139,755	$ 125,206	$ 275,098	$ 168,659

(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 March 31, 2017 are:

	Number of RSUs
Balance as at September 30, 2016	451,030
Granted	489,000
Balance as at March 31, 2017	940,030

Using an estimated forfeiture rate of 10% for the six months ended March 31, 2017 and 2016, 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 March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Total compensation - RSUs	$ 170,541	$ 120,343	$ 239,149	$ 152,311

(d) *Warrants:*

Warrants outstanding as at March 31, 2017 are:

	Number of warrants	Weighted average exercise price
Balance as at September 30, 2016	1,327,500	$ 1.50
Expired, February 26, 2017	(1,327,500)	1.50
Balance as at March 31, 2017	-	$ -

(In Canadian dollars)

7. Related party transactions:

(a) The remuneration of key management personnel:

	Three months ended March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Salaries, accrued bonuses, and employee benefits	$ 247,556	$ 261,840	$ 470,922	$ 562,544
Share-based payments	249,748	185,243	397,535	241,369
	$ 497,304	$ 447,083	$ 868,457	$ 803,913

(b) As of March 31, 2017, amounts owing to a company controlled by an officer and director of the Company included in accounts payable and accrued liabilities were $313,709 (September 30, 2016 - $285,509).

(c) Legal and professional fees, taxes and disbursements totaling $27,001 for the three months ended March 31, 2017 (March 31, 2016 - $43,591) and $61,554 for the six months ended March 31, 2017 (March 31, 2016 - $65,077) were incurred with a law firm of which a director of the Company is a partner. As of March 31, 2017, amounts owing to this company included in accounts payable and accrued liabilities were $86,760 (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 March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Accounts receivable	$ (886,360)	$ 550,090	$ (967,848)	$ 474,241
Inventory	82,348	8,260	(9,279)	183,174
Prepaid expenses and other assets	(16,201)	(2,583)	20,678	(11,655)
Accounts payable and accrued liabilities	347,400	222,568	346,513	(190,085)
Deferred revenue	-	(39,396)	-	-
	$ (472,813)	$ 738,939	$ (609,936)	$ 455,675

(b) *Interest and income taxes:*

During the three months ended March 31, 2017, the Company paid $153,956 in interest (March 31, 2016 - $30,658). During the six months ended March 31, 2017, the Company paid $310,551 in interest (March 31, 2016 - $62,658). The Company did not pay any income taxes during the three and six months ended March 31, 2017 and 2016.

(In Canadian dollars)

8. Supplementary cash flow information (continued):

(c) *Cash and cash equivalents:*

Cash and cash equivalents are comprised of:

	March 31, 2017	September 30, 2016
Cash	$ 724,030	$ 644,490
Term deposit	667,484	2,668,201
	$ 1,391,514	$ 3,312,691

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 March 31, 2017, the Company had one customer who represented greater than 10% of total revenues. This customer from our Optics segment represented approximately 71% of total revenues (March 31, 2016 - two customers represented approximately 46% from our Optics segment and 12% from our Tactical segment).

During the six months ended March 31, 2017, the Company had one customer who represented greater than 10% of total revenues. This customer from our Optics segment represented approximately 71% of total revenues (March 31, 2016 - two customers represented approximately 35% from our Optics segment and 23% from our Tactical segment).

March 31, 2017	Optics	Tactical	Total
Total current assets	$ 2,964,217	$ 494,632	$ 3,458,849
Property, plant and equipment	16,620,271	25,679	16,645,950
Intangible assets	680,619	-	680,619
Goodwill	1,388,458	-	1,388,458
Total current liabilities	4,562,222	179,859	4,742,081
Total liabilities	8,396,959	179,859	8,576,818

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

(In Canadian dollars)

9. Segmented information (Continued):

Three months ended March 31, 2017	Optics	Tactical	Total
Revenue	$ 1,418,644	$ 344,956	$ 1,763,600
Cost of sales	482,844	229,944	712,788
Gross profit	935,800	115,012	1,050,812
Expenses	2,244,459	250,305	2,494,764
Other expenses	250,221	717	250,938
Net loss	$ (1,558,880)	$ (136,010)	$ (1,694,890)

Three months ended March 31, 2016	Optics	Tactical	Total
Revenue	$ 644,949	$ 303,271	$ 948,220
Cost of sales	264,471	190,747	455,218
Gross profit	380,478	112,524	493,002
Expenses	2,488,046	281,722	2,769,768
Other expenses	172,325	919	173,244
Net loss	$ (2,279,893)	$ (170,117)	$ (2,450,010)

Six months ended March 31, 2017	Optics	Tactical	Total
Revenue	$ 2,113,115	$ 557,498	$ 2,670,613
Cost of sales	599,313	389,212	988,525
Gross profit	1,513,802	168,286	1,682,088
Expenses	4,308,497	484,862	4,793,359
Other expenses (income)	436,946	(47)	436,899
Net loss	$ (3,231,641)	$ (316,529)	$ (3,548,170)

Six months ended March 31, 2016	Optics	Tactical	Total
Revenue	$ 1,214,416	$ 1,243,044	$ 2,457,460
Cost of sales	411,233	804,805	1,216,038
Gross profit	803,183	438,239	1,241,422
Expenses	4,780,541	514,046	5,294,587
Other expenses	139,323	3,857	143,180
Net loss	$ (4,116,681)	$ (79,664)	$ (4,196,345)

(In Canadian dollars)

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 March 31,		Six months ended March 31,	
	2017	2016	2017	2016
Salaries and benefits	$ 1,084,861	$ 1,017,634	$ 1,937,221	$ 2,007,531
Share-based compensation	310,296	245,549	514,247	320,970
Depreciation and amortization	733,893	774,574	1,463,594	1,548,069
Travel and entertainment	68,186	106,077	134,850	213,458
Professional fees, legal, and insurance	194,532	187,625	369,931	416,711
Public company costs	169,422	213,546	337,922	388,318
Rent and utilities	187,597	185,721	303,779	370,480
Repairs and maintenance and office expenses	136,225	49,083	221,068	119,781
Materials consumed	322,540	445,177	499,272	1,125,307
	$ 3,207,552	$ 3,224,986	$ 5,781,884	$ 6,510,625

11. Subsequent event:

Subsequent to the quarter end, on May 18, 2017, the Company completed a bought deal private placement with a syndicate of underwriters whereby a total of 11,586,870 common shares of the Company have been issued and sold, at a price of $1.15, for total gross proceeds of $13,324,900.