



Nanotech Security Corp.

**First Quarter 2018 Results Conference Call
(Edited)**

February 22, 2018

CORPORATE PARTICIPANTS

Troy Bullock, *President and Chief Financial Officer*

Doug Blakeway, *Chairman and Chief Executive Officer*

CONFERENCE CALL PARTICIPANTS

Pardeep Sangha, *Haywood Securities*

Anthony Prost, *GMP Securities*

PRESENTATION

Operator:

Good afternoon, and thank you for joining us to discuss Nanotech Security Corporation's results for the first quarter ended December 31, 2017. On the call today we have Nanotech's Chairman and Chief Executive Officer, Doug Blakeway, and President and Chief Financial Officer, Troy Bullock.

At this time, all participants are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session. Instructions will be provided at that time for you to queue up. I will now turn the call over to Troy Bullock.

Troy Bullock:

Thanks, Renee. Good afternoon, and thank you for attending our conference call for the first quarter ended December 31, 2017. Doug Blakeway will begin the call today with an overview of our quarter and a brief discussion of our results for the three months ended December 31, 2017. I'll then give a detailed review of our financial performance and pass the call back to Doug, who'll provide an update on the opportunities we're working on. Following the formal presentation, we would be pleased to take questions.

However, before we talk about results, I'd like to remind everyone that certain statements in this call may be forward-looking in nature. These include statements involving known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from those expressed or implied in the forward-looking statements. For caveat to both forward looking statements and other risk factors, please see our MD&A for the year ended September 30, 2017, which can be found on the Company profile at sedar.com.

Also, as part of the Company's business involves dealing with national currency matters, you will appreciate that we are quite limited in our ability to provide details about specific customers and products

or prospects. That said, we will do our best to provide investors with a general feedback to companies receiving from our customers, the industry, new opportunities that we are pursuing and get some general parameters on how these contracts normally develop into and advance into full deployment on banknotes and security features.

I'll now pass the call over to Doug. Doug?

Doug Blakeway:

Thanks, Troy. Good afternoon, and thank you for joining Nanotech's 2018 First Quarter Conference Call. I want to start by saying that once again we're very pleased with our Q1 financial and operating results. This is our third consecutive quarter of positive Adjusted EBITDA and this quarter we also achieved positive net income which is a significant milestone.

Our cash balance remains very strong with almost \$11 million in the bank and we have no debt. Given our outlook and opportunities to accelerate our growth, we have also recently added new personnel to strategically grow into new markets. Over the last several quarters, we have constantly made progress in the banknote space. Our plan is to disrupt the banknote market and become a key supplier, as winning this market validates our technology and allows us to win additional anti-counterfeiting markets as well. Contrary to public belief, banknote growth is not declining globally. It is actually increasing. Bank Board reported overall demand for cash in Germany, the Eurozone's largest economy, increased 7% last year which is almost twice its normal growth rate. We now have a strong position in the banknote market and are working with many of the world's leading issuing authorities.

I'm pleased to say that we are not only executing on existing business opportunities with these customers, but also seeing the potential to expand our business with them. The sales cycle in banknote market is long. However, we are currently working towards incorporating our nanotechnology security features onto specific banknotes and are actively designing new security features that we feel increasingly—that we feel increasingly confident will be included in future banknotes. Once a feature is included into a banknote, we would benefit from high-margin recurring revenues for many years.

After establishing our successful relationships with banknote-issuing authorities, we decided late last year to accelerate our growth into new markets. I'm happy to say that we continue to make progress towards signing a master agreement with Kumbhat in India, and are making progress into the Indian tax stamp market, something which we have discussed in the past. Indian authorities issue about 28.6 billion tax stamps each year in 29 state excise departments, and we believe we are well on our way to winning a portion of this business in the coming quarters with opportunities for the entire market over the long term. Kumbhat is also pursuing other large opportunities in India outside of the tax stamp market and we will update investors as these opportunities are attained.

Before I hand the call over to Troy to discuss the financial results for the quarter, I would also like to add that we have expanded our Vancouver location by 2,500 square feet to support sales and development activities. We have also recently hired a new Vice President of Marketing and a Vice President of Finance, along with additional staff to support our future growth. Globally, counterfeiting continues to increase. Banknotes and tax stamps represent markets that require the most sophisticated anti-counterfeiting technology. Based upon our success in these markets, we are seeing strong interest from the consumer, pharmaceutical, and luxury good markets. The interest is too strong to ignore so we are investing in sales and marketing personnel and activities to penetrate these markets. I look forward to updating you as we make progress into these new markets where we believe our technology is very well-positioned to outperform against existing anti-counterfeit solutions.

With that overview, I will now pass the call over to our President and Chief Financial Officer, Troy Bullock, to discuss the Q1 financial results in detail and then we'll return for some closing remarks before we take questions. Troy?

Troy Bullock:

Thanks, Doug. Again, good afternoon, everyone. First, I'd like to mention that all the dollar amounts I refer to are in Canadian Dollars unless otherwise stated. Revenues for the first quarter of 2018 increased by \$1.5 million, or 222%, to \$2.2 million, compared to \$694,000 in the same period last year. Revenue growth was primarily due to increased revenue from our development contracts and from increased revenue from our Thurso operations.

During 2017, the Company disclosed a development contract for up to \$30 million over a period of up to five years. These development activities incorporate both nano-optic and optical thin-film technologies and are focused on developing authentication features for future banknotes. This project is continuing to progress well and is positioning the Company for continued revenue growth from development activities.

Gross margin for the quarter of 2018 increased by \$1.1 million, or a 189%, to \$1.7 million, compared to \$578,000 in the same period last year. Overall, the gross margin percentage decreased to 75% from the three months ended December 31, 2017, down from 83% in the same period last year. The decrease reflects increased labor and material costs in the development contracts and lower margins on our Thurso operations' revenue.

Research and development expenditures for the first quarter of 2018 decreased by \$28,000, or about 8%, to \$346,000, compared to \$375,000 in the same period last year due to larger portion of the salaries and other expenses being allocated to cost of sales as a result of increased development project activities, offset by increased patent work and overall higher salary costs related to additional technical staff who were hired in the second quarter of 2017.

General and administrative expenses for the quarter—for the first quarter of 2018, were \$542,000, consistent with the same period last year. Sales and marketing expenditures for the first quarter of 2018 were \$457,000, an increase of \$31,000, or 7%, compared to \$426,000 in the same period last year. The increase mainly relates to increase in travel and marketing expenses. The sales and business development activities continue to focus primarily on demonstrating the Company's technologies to top issuing authorities in the banknote market as well as other prominent partners in the tax stamp and packaging markets.

Depreciation and amortization expenditures for the first quarter of 2018 were \$310,000 compared to \$721,000 in the same period last year, reflecting the Company's declining balance depreciation policy and the intangible assets being completely amortized at the end of September 30, 2017.

Other income for the first quarter of 2018 was \$81,000, an increase of \$268,000 compared to other expenses of \$187,000 in the same period last year. The increase includes \$36,000 of interest income in the current quarter compared to finance expenses of \$231,000 in the same period last year.

Adjusted EBITDA for the first quarter of 2018 was \$460,000 compared to a negative \$556,000 during the same period year. The improvement reflects an increase in revenues and reduced expenses, partially offset by lower margins. The net income for the first quarter of 2018 was \$96,000, a significant milestone improvement compared to the net loss of \$1.9 million during the same period last year. The increase in net income reflects an increase in revenues, reduced operating expenses and amortization, partially offset by lower margins.

During the quarter, the Company spent approximately \$700,000 related to equipment purchases including deposits. These purchases included a steam boiler for our Thurso facility and our new state-of-the-art e-beam system. A further \$1.4 million is planned for the second quarter. These equipment purchases will have an immediate impact on revenue. The boiler in the Thurso facility amounted to approximately \$350,000 and is being used to supply steam for both our facility and for two neighboring facilities. That will generate approximately \$300,000 in revenue for the Company each year.

The new e-beam system was listed at over \$3.5 million and the Company was able to negotiate a significantly discounted price of less than \$2 million by agreeing to house the equipment and promote it at Simon Fraser University. This new e-beam will enable the Company to develop larger, more advanced KolourOptik images and will be used immediately on paid development work and other opportunities with an hourly charge out rate on the equipment, amounting to upwards of \$500 an hour.

The Company ended the quarter with \$10.9 million of cash and cash equivalents, up marginally from the year end of September 30, 2017. The Company has now recorded its third consecutive quarter of positive Adjusted EBITDA. For 2018, the Company is well-positioned financially to pursue opportunities in the banknote, tax stamp and commercial markets. The Company does not normally provide quarterly guidance, however, in our business, there is an inherent variability in the development contract revenue and government organizations. As such, to ensure investors have clear visibility, Management is projecting second-quarter revenue of \$1.9 million with a significant growth in the second half of the year. With our strong balance sheet, including \$10.9 million cash and no debt, Management continues to be on track to deliver strong annual financial performance, in line with its year-end guidance.

This concludes my comments on the Q1 2018 financial results. I'll now pass the call back over to Doug for information on some new initiatives and the outlook for the future. Doug?

Doug Blakeway:

Thanks, Troy. As you heard from our financial results, Nanotech is financially solid and we're ready to accelerate our growth opportunities into new markets beyond banknotes. On our last call, we told investors that Management had established the following goals for 2018: one, grow the existing customer revenues by 20% to 40%, recognizing some inherent lumpiness to the business, planning for the first half of the year being lower than the second half of 2017; begin to collect revenue from the tax stamp and commercial markets; three, a strong focus on earnings with a target of 15% to 20% Adjusted EBITDA margin; four, continuing to pursue a volume optical thin-film partnering opportunity with Hueck Folien and other partners for banknotes; five, invest in several key marketing hires to ensure the internal resources are in place to develop the product sales channels and marketing materials necessary to penetrate potential commercial markets; and continuing, under six, to open new corporate development opportunities by partnering with established companies to enable nanotech to enter new markets.

We continue to work with our partner Hueck Folien for a large optical thin-film order. Hueck Folien had manufactured and shipped products, however continues to face challenges in meeting the required product specifications. We remain confident in their ability to deliver. However, we cannot predict the timing around them being successful. All we can promise shareholders is that we will update them as we learn more about this opportunity. Protecting the Company's technology with patents is becoming more and more important. Nanotech recently announced that the Chinese Patent Office has granted the Company a new patent in nano-optic technology. This patent expands nanotech's proprietary patent portfolio with additional protection of the Company's next-generation color optic technology. Nanotech now holds 21 issued patents in the areas of nano-optic technology and color shifting optical thin film. With more than 30 additional patent applications pending in over nine countries, Nanotech looks forward to future protection of its technology in the future.

By continuing to invest in research and development, the Company will expand its intellectual property, including patents, and ensure the investment provides value and benefit to the Company and our Shareholders. In closing, we remain confident that we're on track for continued growth in fiscal 2018. We've been building our banknote development contracts and anticipate that development revenue will continue to grow, positioning the Company for long-term recurring licensing revenues in the future. In addition, we are actively pursuing new markets where we believe we're well-positioned to win new business which, if successful, will also be high margin recurring business.

With that, I thank you, all, for joining us today. Operator, would you please open the call for questions.

Operator:

Thank you. If you would like to ask a question, please signal by pressing star, one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star, one to ask a question. We'll pause for a moment to allow everyone an opportunity to signal for questions.

Our first question comes from Pardeep Sangha with Haywood Securities.

Pardeep Sangha:

Hi. Good afternoon. With regards to the Hueck Folien working with the Asian customer, if you can provide some more color? Is there anything else either you can do, or is it just between Hueck Folien and the Asian customer right now, or is there something else that you need to do or provide, or just some color on that?

Troy Bullock:

Yes. Hi, Pardeep. It's Troy speaking. I'll take a stab at answering that or giving you a bit more color. During this time, we continue to have a significant relationship with the end customer. We're working with the Asian customer pretty much every few weeks on this opportunity, as well, with other opportunities and and that relationship is very strong and we continue to be quite optimistic that the demand is there for this product. Our challenge has come with the complexities, for introducing a new product like this into an existing manufacturing facility and, initially, we had the belief, and as did our partner, that they could quite easily manufacture this product. They've since proven that they're having some troubles with it. It's taken the better part of a year, that they've been struggling with it.

What we are trying to do is offer our support to go over there. We've got a lot of expertise, as you would know, in making the product and so we're trying to manage the customer's expectations but we're also trying to provide support where our partner allows us. But, they're quite a large organization. It's a billion-dollar organization, themselves, and they've got their own production facilities and know-how and they need to figure it out themselves.

We're trying to monitor them. However, it's just something that they're working through and we're trying to manage the customer's expectations along the way.

Doug Blakeway:

I'd just add to that, Pardeep, that it's taking a little longer than we all thought but there's a reason in the industry that there's no other market players or entities that are doing this because it is extremely difficult to do and finalize. We're down now to the very end of that process and we're looking forward to it being

successful. But again, it's taking longer than both parties, ourselves and them, had anticipated in going through this process.

Pardeep Sangha:

But these challenges you talk about, these are things that you believe will be tackled and will be addressed. There is nothing here that's insurmountable?

Troy Bullock:

We don't believe so. We get the sample reports and they're not far off. They're pretty close but they're just not quite good enough yet and they've got a lot of ideas as to how they can improve. Some of it meant buying new equipment and sensors and the ability to fine-tune their machines and so they've been doing that. They have invested a lot of money into their equipment already, and yes, we still believe, as do they—we get a lot of our confidence from what they're telling us—but they're quite confident they are going to get there. It's just taking them longer.

Doug Blakeway:

Each time we run rolls there is a dramatic improvement and we hope to carry that right through to the end.

Pardeep Sangha:

Okay. In terms of the tax stamp opportunity, I think last time you mentioned something about entering into negotiations with your partner in India, is that kind of where you guys are at, or, give a sense of if you're, in turn, negotiating contract or is there something else going on there or what stage are you guys at there?

Troy Bullock:

Yes, again, it's Troy. Let me try and add some color to that. We initially worked on an agreement with them, sorted out negotiations, if you will, on pricing and things like that, specifically for the tax stamp market and had done that quite some time ago. The opportunity actually expanded because the customer, or our partner, if you will, became more interested in the whole country, including markets outside of tax stamps and had interest to grow their other relationships in packaging, foils and things like that. The scope of the project increased quite significantly from being just a tax stamp provider. Where we're at now is we've spent the last three months, framing out what that arrangement would look like and working on finalizing agreement and I'd say, at this stage, we're very close on that agreement. I would expect that we would have something that we could be talking about in very short order. We've been back and forth with a number of revs and it's really just small points right now and I would expect that to be concluded very quickly.

Doug Blakeway:

The other thing is that, because we've done so much work on it, it's not going into an LOI, it's going into a finished agreement. This will be a completed agreement when we close it.

Pardeep Sangha:

Okay, so then once you come to an agreement, and then, in order to get to sort of ramping up in terms of setting up the manufacturing or delivery of some product, how long is that from agreements to, sort of, I guess, product delivery or revenues? How long is that time frame?

Troy Bullock:

Yes, I guess I want to be a little bit careful on committing to what that is, again, because we're learning from things that we've done in the past. We're an arm's length removed from this. What we understand is, from our own research and what we've been told by our customer, we know the size of that tax stamp market. It's almost 29 billion tax stamps each year. At the same time, we've been introduced and had direct one-on-one meetings, or, with our partner, with a number—upwards of about a dozen different companies over there in the foil manufacturing and other packaging type areas and so the next step, or to convert that revenue, is going to really be reliant on our new partner and I can stay they're a large organization. They're extremely interested in doing this. Once this agreement's signed, they're very excited to get going on that but we're not in a position at this stage to say, "Hey, here's how that looks like and how it ramps up." All I can tell you is that we're very close on signing that agreement and they're very excited on getting going on it and we'll know more as they get going.

Pardeep Sangha:

Okay. All right, and then just in terms of next quarter, you mentioned that it's going to be a little bit down here from this quarter in terms of expectations. Where is the decline, what are you guys—where is the decline coming from?

Troy Bullock:

Yes, the decline relates to timing of revenue recognition in a couple of the development contracts. The contracts themselves have actually grown. It's not that it's lost revenue. It's just not going to fall in the March quarter end, it's going to fall in the next quarter end. There's a number of different reasons around that, just in some of the delays in this new equipment that we received, we weren't able to start that work on time. Some of the projects we have to finish, and it's going to slip into the next quarter but it still falls within the same year-end, it just moves it into the second half. In fact, overall, that development revenue is continuing to grow quite nicely. It, by no means, is a slippage in revenue overall, it's just a six-week delay in timing of it.

Pardeep Sangha:

Okay. All right, thanks. That's it for me.

Troy Bullock:

Thanks, Pardeep.

Operator:

Thank you. Once again, that is star, one if you have do a question, and our next question comes from Anthony Prost with GMP Securities.

Anthony Prost:

Gentlemen, congratulations on the good quarter.

Troy Bullock:

Thanks, Anthony.

Anthony Prost:

Thank you for, first of all, giving a little bit more color on that Indian opportunity and just a very quick follow-up on the guidance that you had mentioned earlier in the call. Are you still looking at having that 20% to 40% revenue growth and the 15% to 20% Adjusted EBITDA margin for the year?

Troy Bullock:

Yes. We're still quite confident in the guidance that we set out for the year, for sure.

Anthony Prost:

Perfect, and then my next question would be revolving around those two new hires that you had. What are your expectations for the new hires, especially the marketing one, considering they're coming from a different industry, to one that is, I'm sure, quite different? As far as speaking to central banks or things like that, how quickly do you expect to ramp up there?

Troy Bullock:

Yes. Let me try a little bit of color in there, because we're going to be adding a number of different people to the organization. These two have certainly joined us initially. They literally joined us a few days ago. They've been here for about three or four days. They're still, obviously, as you can imagine, getting up to speed. First of all, the VP Finance, the key point on that hire is to, frankly, take over a big portion of the work that I've been doing. About 60% to 70% of sort of my more day-to-day financial responsibilities with respect to accounting and things like that, I'm going to be able to pass on to her. She has a tremendous experience in that area and that's going to allow me to spend a lot more time both on the marketing side, and the product development side, as well as supporting Doug in the business development side.

With respect to the marketing person, you're right, Joe Vosburgh doesn't come with a specific direct nanotechnology background or even banknote background, but he does have a very strong background, upwards of 20 years, providing product marketing, strategic marketing for technology companies with a focus and a specialty on taking a new product into a new market very successfully, and where we're at right now as an organization, we've got tremendous contacts in the marketplace. We're rich in technology and, really, that next piece for us to start to drive further revenue into some of these new verticals, is to really understand exactly what that product roadmap needs to look like, build the collateral to go into selling and create selling campaigns to go into these markets, and improving just our overall communication.

He's very well suited for that and he's going to hit the ground running but we're not done there. We're still looking at another couple of really important hires that are going to come from the direct experience, from the more commercial market, and they haven't quite joined us yet but we've met some really tremendous people and I would think, certainly, in the next quarter, we're going to have something more to talk about there and that's going to be to help us actually drive direct revenue in those other markets. Again, these individuals are outside of the banknote space.

Anthony Prost:

All right. Thank you for the color.

Operator:

Thank you.

Troy Bullock:

Thanks, Anthony.

Operator:

Thank you. This concludes our question-and-answer session. Mr. Doug Blakeway, I would like to turn the conference back to you for closing comments.

Doug Blakeway:

Thanks, Renee. I'd like to thank everyone for your questions and for joining Nanotech's first quarter of 2018 conference call. We're pleased with the financial results and growth initiatives that we've put into place and we look forward to updating you on that continued growth path during our Q2 fiscal 2018 call later this year. I'll now turn the call over to the Operator for closing details.

Operator:

This concludes Nanotech Security's First Quarter Fiscal 2018 Conference Call. A replay of this call is available at 1-844-512-2921 for callers in Canada and the United States. The pin number to access this call is 1220038. Thank you, and goodbye.