



Nanotech Security Corp.

Second Quarter 2018 Results Conference Call

May 10, 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 Corp's Results for the Second Quarter ended March 31, 2018. On the call, 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. Please go ahead.

Troy Bullock:

Thanks, Ashley. Good afternoon, and thank you attending our conference call for the second quarter ended March 31, 2018. Doug Blakeway will begin the call today with an overview of our quarter and a brief discussion of our results for the three months ending March 31, 2018. I'll give a detailed review of our financial performance and then pass the call back to Doug, who will provide an update on the opportunities we are working on. Following the formal presentation, we would be pleased to take questions.

However, before we talk about results, I'd like to remind everybody 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 our forward-looking statements. For caveats about forward-looking statements and risk factors, please see our MD&A for the year ended September 30, 2017, which can be found on our company profile at sedar.com.

Also, as part of our company's business involves dealing with national currency matters, you'll appreciate that we are quite limited in our ability to provide details about specific customers and prospects. That said, we will do our best to provide Investors with general feedback the Company is receiving from our customers, the industry, new opportunities that we are pursuing and give some parameters on how these contracts normally develop and advance into full deployment on banknotes and security documents.

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

Doug Blakeway:

Thanks, Troy. Good afternoon and thanks for joining our second quarter conference call. Q2 was another good quarter for Nanotech, on both the financial and operating basis. While Q2 saw slightly lower revenue than Q1, which we guided for on our last conference call, we continue to see strong year-over-year growth with revenue up 37% year-over-year. I'm also happy to announce that this was our fourth consecutive quarter of positive Adjusted EBITDA. We ended the quarter with over \$10 million in cash and we have no debt.

Looking back at the quarter, it was another busy and productive one at Nanotech as we continued to advance opportunities in the banknote, tax stamp pharmaceutical and consumer markets. We also prepared for further growth by adding new personnel, expanding our facility in Burnaby, and investing in strategic equipment purchases, including the Jeol e-beam lithography system that we announced yesterday. These initiatives will enable us to implement our growth strategy, both for the development contract revenues that we have and for markets outside of banknotes.

Our position in banknote market continues to improve and we are well positioned to deliver security features into this market well into the future. Our strategy to disrupt the banknote market and become a key player and supplier is on track and we are now recognized in the industry as having innovative and disruptive technologies to address the needs of issuing authorities around the world. We expect to continue to introduce new and innovative products into this market to maintain our leadership position.

As we've always said, winning this market validates our technology and gives us the credibility as the leader in anti-counterfeiting markets to address additional markets and beyond banknotes. We believe this is starting to happen. Banknote growth continues globally and Bundesbank 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.

I'm pleased to say that we're 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 nano-optics security features on to specific banknotes and are actively designing new security features that we believe will be included in future bank notes. Once the feature is included in a banknote, we would benefit from high margin recurring revenues for many years.

Late last year we decided to accelerate our growth into new markets, including tax stamps and commercial markets. The International Tax Stamp Association states that over 140 billion tobacco and alcohol stamps in the form of a security seal are issued every year by over a 150 Provincial and National revenue agencies around the world, indicating that government and agencies see the value of using them as central features in an effective revenue gathering strategy.

I am happy to say that in our quarter we finalized our supply and license agreement with our partners, Holostik and Kumbhat in India, to initially address the tax stamp and pharmaceutical markets. Both

Holostik and Kumbhat are currently supplying the Indian government with tax stamps and have significant customer lists that include pharmaceutical and some key consumer product companies.

Indian authorities issue above 29 billion tax stamps each year in 29 state exercise departments, and we believe that we are well positioned to win a portion of this business in the coming quarters with opportunities to target 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 obtained.

Before I hand the call over to Troy to discuss the financial results for the quarter, I would like to add that globally counterfeiting continues to increase. Banknote and tax stamps represent markets that require the most sophisticated anti-counterfeiting technology. In 2018, the European Central Bank said that the number of counterfeit Euro banknotes withdrawn from circulation in the second half of 2017 increased 9.7% compared to the first half of 2017 and 2.8% more than the half in the second half of 2016. Last year the Reserve Bank of Australia noted that counterfeiting rate has continued to rise in recent years, albeit from relatively low levels, increasing by an average of 20% per year over the past five years. The Bank of England also indicates that the number of counterfeit banknotes increased from 2015 through 2017.

With that overview I will pass the call over to our President and CFO, Troy Bullock to discuss these Q2 financial results in detail, and then I will return for some closing remarks before we take questions. Troy?

Troy Bullock:

Thank you, Doug, and again good afternoon, everyone. First, I would like to mention that all the dollar amounts I refer to are in Canadian dollars, unless otherwise stated.

Revenues for the second quarter of 2018 increased by \$524,000, or 37% to \$1.9 million compared to \$1.4 million in the same period last year. Revenue growth was primarily due to increase revenues from development contracts and from our Thurso operation. During 2017, the Company disclosed development contracts 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 feature for future bank notes. This project is continuing to progress well, which is positioning the Company for continued revenue growth from development activities.

Gross margins for the second quarter of 2018 increased by \$510,000 or 54% to \$1.4 million compared to \$936,000 in the same period last year. Overall the gross margin percentage increased to 74% for the quarter, up from 66% in the same period last year. The increase reflects a shift to higher margin development projects. Research and development expenditures for the second quarter of 2018, were \$392,000, consistent with the same period last year. General and administrative expenses for the second quarter of 2018 increased by \$48,000 or 7% to \$690,000, compared to \$643,000 in the same period last year. This increase was due to salaries for additional staff hired in the second quarter of 2018 and higher utility cost at our Thurso operation.

Sales and marketing expenditures for the second quarter of 2018 were \$490,000, a decrease from \$520,000 or 6% compared to \$520,000 in the same period last year. The decrease mainly reflects a decrease in non-cash share-based compensation expense in the current period. Depreciation and amortization expenditures for the second quarter of 2018 were \$409,000 compared to \$693,000 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 second quarter of 2018 was \$203,000, an increase of \$453,000 compared to other expenses of \$250,000 in the same period last year. The increase includes \$27,000 of interest income in

the current quarter compared to interest expenses of \$233,000 in the same period last year. Adjusted EBITDA for the second quarter of 2018 was a \$133,000 compared to negative \$268,000 during the same period last year. The improvement reflects increased revenues and higher margins.

Net loss for the second quarter of 2018 was \$285,000, a significant improvement compared to the loss of \$1.7 million during the same period last year. The improvement in our bottom line reflects increased revenue in combination with reduced interest and amortization expenses. The Company ended the quarter with \$10.3 million of cash and cash equivalents, down \$600,000 from the previous quarter due to equipment purchases of \$819,000.

The purchases include research and development casting line and a steam blower for our Thurso facility as well as new state of the art e-beam lithography system. While the equipment was delivered during the second quarter we expect to make additional payments of \$1.6 million in the third quarter with respect to these assets. Each of these equipment purchases is expected to generate revenue. The casting line in Thurso will expand our opportunities for development revenue while the blower will be used to supply steam and heat to our facilities and to two, third party neighboring facilities during the winter months. The new e-beam lithography system is already being used for paid development work and we expect there will be other opportunities to generate revenue with hourly charge-out rates on the equipment.

The Company has now recorded its fourth consecutive quarter of positive Adjusted EBITDA. With our solid balance sheet, increased development contract revenue and advancing customer relationships we are very well positioned to deliver on our 2018 revenue and Adjusted EBITDA goals and to pursue further growth in markets outside of bank notes.

This concludes my comments on the Q2 2018 financial results. So now I'd like to pass the call back to Doug to provide some more information about our new initiatives and other outlooks for the future. Doug?

Doug Blakeway:

Thanks, Troy. As you heard from our financial results, Nanotech had another good quarter and we believe we have a strong foundation to accelerate our growth. I'd like to now reiterate our 2018 goals that we laid out previously and discuss how we are right tracking with each of these goals. Number one, we talked about growing the existing customer revenues by 20% to 40%. So far in the first half of the year we have grown revenues by 98% and based on our projected revenues for the second half of the year we're on track to deliver revenue growth in line with our 20% to 40% growth goal.

The second goal was to begin to collect revenue from tax stamps and commercial markets. In the quarter we finalized our agreements with Holostik and Kumbhat from India to begin production of tax stamp security features into the Indian market. Goal number three, a strong focus on earnings with a target of 15% to 20% Adjusted EBITDA margin. So far in the first half of 2018 we posted an Adjusted EBITDA margin of 14%. While we are just shy of our 15% to 20% target we anticipate stronger Adjusted EBITDA margins in the second half of the year and maintain our goal of hitting the 15% to 20% range for the year.

Our fourth goal was to continue to pursue a volume optical thin film partnering opportunity with Hueck Folien and others for bank notes. We are working with our partners, Hueck Folien to help them improve the quality of their production. 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.

Goal number five, invest in several key marketing hires to ensure the internal resources are in place to develop the products, sales channels and marketing materials necessary to penetrate potential commercial market. In the quarter we hired people in marketing, finance and support roles to lay the

foundation for future growth. In the second half of the year we expect to add several new positions to further support our growth.

Lastly number six, continue to open new corporate development opportunities by partnering with established companies to enable nanotech to enter new markets. In the quarter, we finalized agreements to expand into the Indian market. We continue to work on similar agreements that can accelerate our geographical and end market reach. While we are seeing several opportunities today with discussions on going, the specific timing of finalizing these deals is uncertain.

We continue to remain focused on patents on protecting our IP around the world. Last quarter we announced that the Japanese 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 patented applications pending in over nine countries. Nanotech looks forward to further 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 are on track for continued growth. We've been building our bank note development contracts and anticipate that development revenue will continue to grow, positioning the Company for long-term recurring licensing revenues well into the future. In addition, we're actively pursuing new markets where we believe we are well positioned to win new business, which if successful will also be high margin recurring businesses.

I'll now ask the Operator to open the call to questions. Ashley.

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, it is star, one. We will pause for a moment to allow everyone an opportunity to signal for a question.

We'll take our first question from Pardeep Sangha with Haywood Securities. Please go ahead.

Pardeep Sangha:

Hi, thank you. In terms of the Hueck Folien and the Asian opportunity, just can you give us a sense, I understand you are not able to give us the time for when this could go into full production, but give a sense of kind of what developments happen sort of over the past quarter. Kind of was there another test run, was there some additional equipment that was installed or what testing was down, or just give us a sense of that, there's still progress going on and what kind of stuff you guys did?

Doug Blakeway:

Okay, thanks, Pardeep. It's Doug, and I'll answer the question. I guess we continue to believe the volume color shifting optical thin film is a growth opportunity. With the Chinese 10 Yuan banknote currently having a color shifting optical thin film thread, and other Asian countries designing the color shifting optical thin film thread into the bank note, the market opportunity for large volume stays significant. I can say that we're still working with our European volume production partner, Hueck Folien and it's going very

well and we are making great strides. We are there to help them become qualified as the optical thin film supplier. However, again I have to reiterate at this point in time we can't specify how long it's going to take. Just general improvements have been made during the last quarter to significantly advance this.

Troy Bullock:

Pardeep, hi, it's Troy. I could also add to that. there is regular activity going in with Hueck Folien. We are in contact with them, having weekly meetings and they are continuing to work at this quite actively. It's not a dormant project or anything like that. They have made some progress. We are progressing, but there is still a few hurdles for them to get over before we are at a stage where we are comfortable that it's a quality product that we would submit to a customer. But the effort is still going and it is still a priority for them.

Pardeep Sangha:

I guess do you feel that these hurdles, that they are going to get through are either all pretty achievable objectives. They don't think there's anything that's not achievable there?

Doug Blakeway:

That's correct. I mean they keep making good progress. They bought few more pieces of equipment in the last sort of three four months that helped again with that. But yes, there is nothing that we can see that prevents us or provides caution to us that they won't be successful. We are encouraged by the continued pursuit, we are encouraged by their spending and we're encouraged by the progress that they are making. It's just hard for us to pin down or even for them to estimate. They are not comfortable estimating to us when they think they'll be finished. They are just working at it.

Pardeep Sangha:

Okay, and then if we talk about tax stamp and India opportunity, just give us a sense of kind of where some of these—like you said you're expecting some sort of revenue coming here shortly, so in the next couple of quarters. So what gives you that sort of confidence, like I mean are you then like giving RFPs or you like what are you sort of doing, are you doing test runs for end customers, or like just give a sense of what are you doing with the end customers that gives you that confidence that their revenue is going to come in the next couple of quarters.

Doug Blakeway:

It's Doug, Pardeep. We are very excited about our partnership with Holostik and Kumbhat. They're marketing our technologies to their existing customer base and to the broader Indian markets. It's at an early stage and we have not forecasted any significant revenue in our fiscal 2018 forecast. However, there are opportunities where they could generate modest revenue over the next couple of quarters and we see them branching into the tax stamps and pharma markets as we go forward.

We are at a stage where we're making master shims for doing printing. So they'll be able to take those and canvas them with their customers and they have been getting very good indications back from their customers wanting to move on to our type of technology. So everything is looking very good. It's just at the initial stages of putting it together and so rather hard to forecast, until probably at the end of next quarter.

Pardeep Sangha:

Okay. Troy, if you can just go over that cap ex spend again. I think you mentioned that you expect \$1.6 million in Q3 of the cap ex spend, is that correct and then I think that the press release with regards to your e-beam, new e-beam lithography equipment was for \$4.4 million. So just give us a sense of like when is that \$4.4 million, and how does that come over into the—to your cap ex spend and where should we be allocating (phon) that?

Troy Bullock:

Yes, let me clarify a couple of those points. So we brought a number of pieces of equipment this past three or four months. That included the boiler in Thurso, an R&D casting line, and that also included a—the EBL system that we have here in Burnaby. To touch on the earlier ones first, the casting line, we actually received funding from that as part of a development contract earlier in the year. So the costs related to that, were actually paid for by a customer. It's our system but we were able to fund that activity by a customer.

The boiler activity, which was about \$350,000, that's an investment on our part because we bought a larger one, so we could actually sell and supply steam to our neighbors. So it's actually a revenue generating opportunity for us. The most significant piece for us was this Jeol EBL system that we have here in Burnaby and just to be clear, Pardeep, it was valued at \$4.4 million. But, since we were the first private Company in Canada to purchase one of these systems as they are typically in the United States to large universities. So because of us being the first private Company we were actually able to buy this system for less than \$1.9 million. We took position of that asset in the quarter. It's in our balance sheet and the remaining \$1.6 million of that is sitting in accounts payable and we paid it off in the third quarter.

That covers off all the expenditures. We're not having additional expenses related to that, just the final payment was still sitting in AP and I really must say this EBL it's a pretty significant improvement and purchase for us. It will allow us to fabricate more advanced nano structures at even higher resolutions and contrast. We have the potential to generate images up to nine times bigger than what we're currently producing and estimate that we can do up towards of ten times faster. We've already begun using the system to generate revenue on these development contracts even in the second quarter and certainly plan to do further revenue from it in the third quarter.

Pardeep Sangha:

Okay, that's great. Thanks for clearing that up. One other question Troy is the headcount, what was your headcount at the end of the quarter and if there's any changes to the end of the quarter to today?

Troy Bullock:

Yes, we're at 28 headcount plus there's four people still in the tactical in the United States. We anticipate that being concluded in the next couple of months. So we'll resume back down to 28. Looking ahead through the sort of next couple of quarters there is still a need for us to bring in some sales people and some sales support, and so I see a couple of three more people being added over the next quarter or two.

Pardeep Sangha:

Okay, thanks very much, guys. That's it from me.

Doug Blakeway:

You're welcome. Thanks, Pardeep.

Operator:

We'll take our next question from Anthony Prost with GMP Securities. Please go ahead.

Anthony Prost:

Good afternoon, gentlemen. You've commented on your interest in pursuing commercial opportunities in the pharmaceutical and cosmetics industry. I wanted to ask if there were any other opportunities you could comment on beyond those. If you could provide maybe some color as to the importance of the general commercial opportunity, say compared to your, like your bread butter tax stamp and banknote.

Doug Blakeway:

Hi, Anthony, it's Doug. I think the area to explain is we're seeking other opportunities and we're having our marketing area inside the Company now defining on where we're going with those. They are taking our specific technologies or products that we've developed for tax stamps and modifying them into the commercial area. If you think into pharma and blister packs, be something to tell you that that's the back of the blister pack, that's aluminum foil doing areas into that and incorporating it.

There is also some incorporation into other security supplies that requires things such as our optical thin film being used in a dramatic new way. I really don't want to comment on how it's used, as it's done in an experimental basis and can be a game changer for our customer. So we're keeping that sort of on sideline right now in experiments, but that could also be a very good revenue source for us.

We don't have anything other than that specifically that we're doing that, that I can announce a contract on but we have many opportunities where they're looking at in the commercial environment from luxury goods, to again the pharma and the pharma being not necessarily right on the pill but more on the packaging aspect of it. Along with that we have an opportunity on a cosmetic line in a foreign country that's being worked on. But those would be our main areas where we're adopting our technology and moving it over.

Anthony Prost:

All right. Thank you.

Operator:

As a reminder if you would like to ask a question it is star, one. We will pause for a moment to allow everyone an opportunity.

We do have a follow up question from Pardeep Sangha with Haywood Securities. Please go ahead.

Pardeep Sangha:

Hi, thanks again. At your AGM you mentioned something about a product launch coming up in end of May. Is there anything more you could tell us about that?

Doug Blakeway:

Sure, Pardeep, it's Doug. We are launching a product called M Squared. That is being launched in Dallas, Texas on Wednesday May 23. It's primary goal was as a security feature, but it can go off into other areas

and commercial with adaptation of it. But as a security feature it is something that we call it's multi-directional movement. So it has movement, it has size movement, meaning it grows and shrinks. It can go and move in any direction. It's made up of a number of frames of video, very high number. It is something to compete with anything that's out there in the field that has movement in it. It is an extremely thin technology. It runs at about five microns in thickness, to give you an idea. It's an area that can be transferred into all sorts of products. So allow us to expand it.

I'm a little reluctant to say because—exactly what we're doing, because of the announcement on the 23rd and at that time we're going to expose it to all the markets and we'll have a follow-up news release on what it's like, videos and presentation materials.

Pardeep Sangha:

Are there any sort of specific vertical industries that you would be targeting more than others for this application or for the new product

Troy Bullock:

Yes, hi, Pardeep, it's Troy. This market—this product is clearly targeted at the banknote market. There is different applications from it or some things that we can adapt from it that would go into other verticals. But this is a pretty important event for us. This banknote conference is a very prestigious high profile event where all the major players from around the world show up. We've got a very prominent release scheduled for that, that everybody is quite excited about. Once we've announced, and we're currently being very vague to our customers and partners as to what the merits and the benefits of this new product is going to be. We're extremely excited about it. Once we show that we will have news announcement to the market at that point in time. But at this stage, we're just sort of teasing the customers, if you will to come out and see it. We're going to be very excited to show it to the market once it's launched.

Pardeep Sangha:

Okay. Great thanks again for taking my questions.

Doug Blakeway:

You're welcome. Thanks, Pardeep.

Operator:

As a final reminder if you would like to ask a question it is star, one. We will pause for a moment. It appears we have no further questions at this time. I would like to turn the conference call back over to Doug for any additional or closing comments.

Doug Blakeway:

Thank you, Ashley. I'd like to thank everyone for your questions and for joining our second quarter 2018 conference call. We're pleased with the financial results and growth initiatives that we've put in place and we'll continue to advance these in the third quarter. These initiatives include the recent brand and website redesign launch at our AGM in early April, and an upcoming new significant product announcement planned for Banknote 2018 in Dallas Texas on May 23. By the way if you go on the web to Banknote 2018 you can see about the Banknote Conference and what it's made up of or more details as well as our supporting role to make our announcement there.

We look forward to updating you on our continued growth path at our next quarter-end conference call. I'll now turn the call over to the Operator for closing details. Ashley?

Operator:

Thank you. This concludes the Nanotech Securities second quarter 2019 conference call. A replay of this call is available at 1844-512-2921 for callers in Canada and in the U.S. The pin number to access this call is 1697009. Thank you, and you may now disconnect.