



Nanotech Security Corp.

Third Quarter 2018 Results Conference Call

August 9, 2018

C O R P O R A T E P A R T I C I P A N T S

Troy Bullock, *President and Chief Financial Officer*

Doug Blakeway, *Chairman and Chief Executive Officer*

C O N F E R E N C E C A L L P A R T I C I P A N T S

Pardeep Sangha, *Haywood Securities*

Anthony Prost, *GMP Securities*

P R E S E N T A T I O N

Operator:

Good afternoon, and thank you for joining us to discuss Nanotech Security Corp's Results for the Third Quarter Ended June 30, 2018. 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 would now like to turn the conference over to Mr. Troy Bullock. Please go ahead, sir.

Troy Bullock:

Thank you, Kelly Ann. Good afternoon, and thank you attending our conference call for the third quarter ended June 30, 2018. Doug Blakeway will begin the call today with an overview of our quarter and a brief discussion of our results. 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 can 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 our forward-looking statements. For caveats about forward-looking statements and other 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 general parameters on

how these development contracts normally advance into full deployment on security features on future bank notes.

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

Doug Blakeway:

Thanks, Troy. Good afternoon and thank you for joining our third quarter conference call. Q3 was another good quarter for Nanotech on both an operational and financial basis. Q3 revenue was consistent with Q2 and we continue to see strong year-to-date growth with revenues up 31% year-over-year. I'm also happy to announce this was our fifth consecutive quarter of positive Adjusted EBITDA. We're very pleased with our Company's progress and feel Nanotech is now at its strongest position in its history. We ended the quarter with \$9.5 million in cash after making significant capital investments during the year, including a state of the art e-beam lithography system used in making KolourOptik images, along with the latest in development and production equipment for our KolourOptik and optical thin film advancement. We continue to own 100,000-square foot building on 11 acres in Eastern Canada with 45,000 square feet dedicated and fully equipped as a high secure banknote production facility and all this with no debt outstanding and five consecutive quarters of positive Adjusted EBITDA.

Smithers Pira reported that central banks are spending over \$12 billion annually on banknotes. Nanotech's primary market continues to be the banknote security feature market which, in itself, is in excess of \$2 billion a year and continues to grow at a compound annual growth rate of over 5%. As we continue to establish our products and technology in this high profile recurring revenue market, we recently unveiled an exciting new security feature called M² at the Banknote 2018 Conference in May. This breakthrough security feature combines multi-directional movement with clear colorful changing images, defining a new category of security feature authentication. Industry experts responded very favorably at the product launch and since revealing the product, we have had significant interest from both issuing authorities and potential partners. We're excited about the market potential for M², particularly as we can produce it in formats and qualities and quantities that can be applied to any banknote substrate.

Nanotech's position in the banknote market continues to improve. Our strategy to disrupt the banknote market and become a key supplier in this \$2 billion market is on track and we are now gaining recognition in the industry as having innovative and disruptive products and technologies to address the needs of issuing authorities around the world. Given this, we expect to continue to introduce new and innovative products into this market to gain a leadership position. As we have always said, winning the banknote market validates our technology and gives us the credibility as a leader in the anti-counterfeiting technology market. I'm pleased to say that we're making significant progress on our banknote development contracts and we are also seeing the potential to expand our business with our existing banknote customers. The sales cycle in the banknote market is long; however, we are currently working towards incorporating our nano-optic security features onto specific banknotes and are actively designing new security features that we believe will be included in future bank notes. Once our features are included in a bank note, we would benefit from high margin recurring revenues for many years.

One of the questions we always get from investors is, "But aren't banknotes going away as we move to a cashless society?" We continue to see a growing population, acceleration of global economic growth and high proportions of cash payments in several countries which indicate that the world won't transition to a cashless society any time soon. Global Security Firm, G4S, notes that over 50% of transactions in North America involve cash. In Europe, 79% of point of sale transactions were settled in cash. Banknote growth continues globally and security features are the key driver. In fact, G4S noted that global cash in circulation relative to GDP stood at 9.6%, up from 8.7% in 2011. Bundesbank Board reported overall demand for cash in Germany, the Euro Zone's largest economy, increased 7% last year which is almost

twice its normal growth rate. The European Central Bank reported that, in 2017, the number of banknotes in circulation grew 5.9% year-over-year. Banknote counterfeiting remains a problem globally, leading issuing authority to ramp up the design and issue of new banknotes.

The European Central Bank note issued a new €50 banknote in 2017 in response to counterfeiting and stopped producing the €500 banknote in 2018 to stop its use for illegal purposes. The European Central Bank also withdrew 301,000 counterfeit bank notes during the first half of 2018. In the first half of 2019, the Eurosystem plans to simultaneously issue the new €100 and €200 bank notes, the last two denominations of the Europa series, to help combat counterfeiting. Last year, the Reserve Bank of Australia noted the counterfeiting rate has continued to rise in recent years from relatively low levels but 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.

Outside the banknote market, late last year we decided to embark on new initiatives with partners to help accelerate our growth into markets that were complementary to our primary \$2 billion banknote market including tax stamps and commercial markets. The international Tax Stamp Association says that over 140 billion tobacco and alcohol stamps in the form of security affixed labels were issued every year by over 150 provincial and national revenue agencies around the world indicating that governments and agencies see the value of using them as a central feature in effective revenue gathering strategies.

Currently, the majority of tax stamps use outdated security features like holograms that are easy to counterfeit. We are starting to see these agencies investing in new technologies as counterfeiting is becoming an issue for governments around the world. Indian authorities issue about 29 billion tax stamps each year in 29 states excise departments. To address this market, last quarter we finalized our supply and license agreements with our partners Holostik and Kumbhat in India, to initially address the tax stamp and pharmaceutical markets system. Both Holostik and Kumbhat are currently supplying the Indian government with tax stamps and have significant customer lists that includes pharmaceutical and consumer products companies. Kumbhat and Holostik are also pursuing other opportunities in India outside the tax stamp market. We will update the investors on these opportunities as they develop further.

Before I hand the call over to Troy to discuss the financial results for our quarter, we're pleased to report that our shutdown of our surveillance and van conversion business has been completed. We sold the business assets during the third quarter and, for the year-to-date, we have been able to recover approximately \$94,000 in cash from this struggling legacy operation. With that overview, I would now pass the call over to our President and CFO, Troy Bullock, to discuss the third quarter financial results in detail. I will return for some closing remarks before we take questions. Troy?

Troy Bullock:

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

Revenues for the third quarter of 2018 were \$1.9 million consistent with the second quarter but down from the \$2.6 million in the third quarter of 2017. This was primarily due to the timing of a recurring annual optical thin film order which is anticipated to be recognized in the fourth quarter of 2018. Our year-to-date revenues increased 31% compared to the prior year, even without this optical thin film order, as a result of expanded development contract revenue.

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 our nano-optic and optical thin film technologies and are focused on developing customized security features for future bank notes. This project is

progressing well and it positions the Company in the near term for continued revenue growth from development activities which could lead to long term recurring revenue.

Gross margin for the third quarter of 2018 remained strong at 83% compared to 84% in the same period last year.

Research and development expenditures for the third quarter of 2018 were \$456,000, 10% higher than the same period last year. This increase was mainly resulted from the timing of the optical thin film ("OTF") deliveries from our Thurso facility as lower OTF deliveries in the current quarter allowed for more research and development compared to the prior year.

General and administrative expenditures for the third quarter of 2018 increased by \$24,000 or 4% to \$702,000 compared to \$678,000 in the same period last year. This slight increase was due to salaries, increased rent and other expenditures related to the expansion of our Burnaby lab facilities.

Sales and marketing expenditures for the third quarter of 2018 were \$569,000, an increase of \$66,000 or 13% compared to \$503,000 in the same period last year. The increase mainly relates to increased marketing expenses such as market research, industry trade shows and the new marketing staff.

Depreciation and amortization expenditures for the third quarter of 2018 were \$395,000 compared to \$664,000 in the same period last year reflecting the Company's declining balance depreciation policy and the intangible assets being completely amortized as of September 30, 2017.

Other income for the third quarter of 2018 was \$52,000, an increase of \$698,000 compared to other expenses of \$646,000 in the same period last year. The increase is primarily due to a reduction in interest expense followed by the repayment of debt in the third quarter of 2017.

Adjusted EBITDA for the third quarter of 2018 was \$100,000 compared to \$858,000 during the same period last year. This decrease was primarily due to reduced OTF revenue in the current quarter in combination with increases in sales and marketing and research and development expenditures.

The net loss for the third quarter of 2018 with \$627,000, an improvement compared to the net loss of \$905,000 during the same period last year. The improvement in our bottom line reflects reduced interest and amortization expenses. The Company remains debt-free and we ended the quarter with a strong cash position of \$9.5 million. Cash decreased by \$1.4 million from September 30, 2017 due to capital investments of \$2.5 million during the year-to-date, partially offset by cash generated from operations of \$1.1 million.

The capital investments included a research and development embedding line and a steam boiler for our Thurso facility, as well as a new state of the art e-beam lithography system. Each of these equipment purchases is expected to generate revenue. The embedding line in Thurso will expand opportunities for development revenue while the boiler is used to supply steam and heat to both our facility 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 that there will be other opportunities to generate revenue with hourly charge-out rates on this equipment.

The Company has now recorded its fifth 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 2018 revenue and Adjusted EBITDA goals and to pursue additional growth opportunities.

This concludes my comments on the Q3 2018 financial results. I will now pass the call back to Doug for further information on our outlook 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 for growth. I would now like to reiterate our six 2018 goals that we laid out previously and discuss how we are tracking with each of these.

Number one was to grow the existing customer revenues by 20% to 40%. So far this year, we've grown revenue by 31% and based on our projected revenues for the fourth quarter, we're on track to deliver revenue growth in the 25% to 35% range.

Number two, begin to collect revenue from tax stamp and commercial markets. This year we had finalized our agreement with Holostik and Kumbhat to pursue tax stamp and commercial security feature opportunities in the Indian market which is proceeding well.

Number three, a strong focus on earnings with a target of 15% to 20% Adjusted EBITDA margin. Adjusted EBITDA margins for the year-to-date are 11%; however we anticipate stronger Adjusted EBITDA in the fourth quarter and are on track to reach our goal of 15% to 20% for the year.

Number four, continue to pursue a volume optical thin film partnering opportunity with Hueck Folien and others for banknotes. While not yet successfully qualified, Hueck Folien has made some significant advancement in closing the gap to meet the production specifications. While we also continue to support their activities, we are unable to provide any update on when they will be successful. At this time, we are not planning for any volume optical thin film revenues from Hueck Folien this calendar year or for the foreseeable future.

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 markets. So far this year, we hired people in marketing, finance and support roles to lay the foundation for future growth. In the fourth quarter of the year, we expect to add several positions in the development and production and sales areas to further support our growth.

Number six, continue to open new corporate development opportunities by partnering with established companies to enable Nanotech to enter new markets. We continue to work on agreements that can accelerate our geographical and market reach. While we are seeing several opportunities today with discussions going on, the specific timing of finalizing these new initiatives is uncertain.

We continue to remain focused on patents and protecting our IP around the world. Nanotech now holds 21 issued patents in the areas on nano-optic technology and color shifting optical thin film. With more than 30 additional patent applications pending in over nine countries, Nanotech remains vigilant about protecting its research and intellectual property. By continuing to invest in research and developments, 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 banknote development contracts and anticipate that the development revenue will continue to grow, positioning the Company for long term recurring licensing revenues in the future. In addition, we've started to explore new markets where we believe we can become positioned to win new business and, if successful, will also be high margin recurring business.

With that, I would like to now ask the Operator, Kelly Ann, to please open the call to questions.

Operator;

Thank you. At this time, if you do have a question, that will be star, one. Again, star, one for questions.

We will go first today to Pardeep Sangha with Haywood Securities.

Pardeep Sangha:

Hi. Good afternoon, guys.

Doug Blakeway:

Good afternoon, Pardeep.

Pardeep Sangha:

Yes, with regards to, you mentioned Hueck Folien and the Asian customer there, you said closing the gap for production. Can you just highlight—just give some more color on that with regards to what exactly you mean by closing the gap and how much work is left or...?

Troy Bullock:

Yes. Hi, Pardeep. It's Troy. Yes, I guess there's been a number of things. As you know and are aware, Hueck Folien has been selected as our outsourcing partner to deal with large volume optical thin film opportunities. In particular, we've been pursuing the one in China, as well as other Asian opportunities related to color shifting optical thin films, so not our KolourOptik products but just specifically for OTF. This past year and certainly even beyond that, Hueck Folien has been working towards trying to get the quality of their production up to a level that we could qualify them so that they could be accepted as a supplier into this Chinese opportunity.

This quarter they did make some really good progress, specifically around some of the earlier issues that they were having related to color but there are still some areas that they still need to make some more progress on. They are still working on that but it's really hard for us to give much further color on how they're going to get there or what timeline they're going to take to get there. At this point in time, we're supporting them. We still are very much of the belief that the optical thin film opportunity is a strong opportunity but at the same time, our primary focus right now is on the KolourOptik products that we're putting out. We'd like to see this large volume optical thin film get over the finish line but at this stage, it's not really within our control so we don't have much visibility to update people on the timing of it.

Pardeep Sangha:

Okay. Fair enough. In terms of the development contracts, can you talk about pipeline? What does the pipeline look like for additional development contracts? In the past you talked about potential for a development contract that may even be bigger than the \$30 million development contract. Just talk about the pipeline and the number of opportunities you might be looking at or how big these opportunities are?

Troy Bullock:

Sure. The development contract, right now, it's a very big part of our current revenue and, strategically, it's probably the most important thing we have as an organization. We received that \$30 million

development contract about 18 months ago, and we've been drawing upon that each year. We have seen revenue growth in both 2017 and 2018 as it relates to that contract, and as we go forward, we still think there's opportunities to see further revenue growth related to that same customer as we are making significant progress and moving up their decision line on that banknote contract. Again, just to be clear on that, Pardeep, what we're doing is working with that country to design a customized KolourOptik and optical thin film feature for their future banknotes.

Although we're enjoying the development revenue now, if and when we're successful on that, the opportunity for recurring revenue as we go into production for that product is very significant. Countries of a significant size could be spending upwards of \$40 million to \$50 million a year of annual recurring revenue related to a security feature and so that opportunity is very important to us. There are other opportunities out there. I wouldn't suggest that they are as large as that contract, but there are certainly countries out there that are much larger. We've been successful getting a development contract with this one particular country and we're optimistic that we're going to be designed into their banknote. We're going to try and take that same approach with other countries and we certainly have at least several other discussions underway trying to proceed with that as well.

Pardeep Sangha:

Would you say that the other development contracts in the pipeline, have you seen progression in your pipeline over the last couple of quarters with the potential for bringing some of these develop contacts to, perhaps even closure by the next couple of quarters, in terms of signing the contract?

Troy Bullock:

Yes, it's hard to put a timeline around it. We are certainly seeing progression on them, Pardeep. We are actually approaching it maybe two different ways; the one way is to work on getting some paid development work out of them to design a customized security feature for them, much like we've done with the other example; but at the same time, what we've also done is we've launched our M² products. We've taken what we think the market is looking for in a security feature, and launched that as a so-called finished product or something very close to what they would be looking for in a security feature. We're working on both approaches: one, to either design something a little bit unique for them which will come through development contract work; or two, to get them to incorporate the M² product offering that we launched in May and to design that into their banknote. We're having some success on both fronts. There is a lot of interest in our M² product and we're still talking to potential customers about a customized product as well. It's probably a quicker path if we can get them to agree on the existing product that we've already launched.

Pardeep Sangha:

Okay, that's helpful. All right. Thanks, I will get back in the queue.

Troy Bullock:

Thanks, Pardeep.

Doug Blakeway:

Thanks, Pardeep.

Operator:

We will go next to Anthony Prost with GMP Securities.

Anthony Prost:

Good afternoon, gentlemen.

Doug Blakeway:

Hi, Anthony.

Troy Bullock:

Hi, Anthony.

Anthony Prost:

We have discussed a lot of opportunities in Asia but I wanted to ask if you're directing your marketing efforts elsewhere in the world. I mean, for example, I've read that, in early 2019, the EU is planning to put in legislation aiming to stop illegal trading of falsified medicines via improved packaging and so forth. Is there any space or even bandwidth, for that matter, for Nanotech on a project like that?

Troy Bullock:

Yes. A few different questions in there, Anthony, and let me try and address them if I can. I guess, on the broader question, are we looking globally? Absolutely. I mean, at this point in time, again, primarily our focus is in the banknote space and we are meeting on a regular basis, weekly, with issuing authorities, central banks, if you will, around the world in upwards of 10 to 20 different countries, showing them our product offerings, showing them our technologies and trying to get ourselves designed into those banknotes. Therefore, on a global basis, that's our primary focus of our marketing efforts.

Outside of banknotes, we are pursuing different activities on a more opportunistic basis. Industry by industry, they're a little bit different but our technology fits extremely well when you're designing a security label for packaging to prevent any counterfeiting. It also has applications for brand enhancement and to differentiate a product in the marketplace. I can't speak to specific product offerings or deals that we're actually working on but we are absolutely looking at that globally. The one example of that, obviously, that we have announced and talked about is our pursuit of tax stamps in India. We've got two great partners that we've signed up this year and they're very actively marketing those products into the Indian market both at tax stamp side but also into some other industries including the packaging as well as pharmaceutical markets.

Anthony Prost:

All right. Thank you. As far as this new M² product, I mean, you spoke that it was well-received and was that a 2019 story or a 2020 story?

Doug Blakeway:

Hi, Anthony, it's Doug. That is an ongoing strategy that we have. I guess the first area that we're going after is on banknotes that would come online earlier than later, such as commemorative banknotes, as well as putting it into stripes on banknotes that are coming up in the near future that can be changed from

something they're presently using today. It's not requiring the normal eight-plus years of development before you're on something. M² is a very unique feature that is very thin (you can't feel it with your hands), it gets placed on a banknote, it can be used as a thread, a patch or a stripe which allow activities right across the board, whether it's on a polymer or a hybrid, which is part polymer and part cotton, or on a cotton paper-based substrate. The response from issuing authorities from that banknote conference has been—we haven't been able to go and meet with all the requests we've had from issuing authorities to see it and see how it could be adopted to their series of banknotes.

Anthony Prost:

That's some great color. Thank you.

Doug Blakeway:

Great.

Operator:

Again, for questions, that is star, one at this time. We will take a follow-up from Pardeep.

Pardeep Sangha:

Hi. Thanks, again. You mentioned there are some referring OTF revenues that was basically pushed back from Q3 into Q4, can you give us a sense of what magnitude we are talking about there?

Troy Bullock:

Yes. This is work, obviously, that we do out of our Thurso facility and when we talk about recurring revenue, it predates our purchase of that business but as I understand it, this group of people have been producing that recurring revenue in excess of 17 years now. When we talk about long term revenue streams, this has been something that we've been doing as a business for a very long time, back in the Bank of Canada days. It's fluctuated from year to year. It's typically gone from somewhere in the \$0.5 million to about a \$1.5 million range, Pardeep. Again, it's a color shifting optical thin film for a banknote that's in current circulation.

Pardeep Sangha:

That's kind of the (inaudible) that was kind of shifted from Q3 to Q4, \$0.5 million to a \$1 million?

Troy Bullock:

No, sorry, what I meant was the typical annual purchase from this country is in the \$0.5 million to \$1.5 million range. I don't necessarily want to say how much has been shifted over into the third quarter—sorry, into the fourth quarter. What I can say on our fourth quarter, we've given pretty specific guidance on our fourth quarter given that we've narrowed our range from 25% to 35% and I think you can sort of back into that as to how much of that would be related to this optical thin film order.

Pardeep Sangha:

Okay, thanks. A follow-up, in terms of the tax stamp opportunity with—I understand things are going quite well with Holostik and Kumbhat but just getting a sense of your pipeline for their customers, what are you

seeing as being sort of—is it the tax stamp stuff or you've also talked about packaging? What are you seeing as being the furthest along and closest to coming to fruition with Holostik or Kumbhat?

Doug Blakeway:

Hi, Pardeep. Its Doug. Both opportunities that you mentioned there in the pharma and the foil business, along with tax stamps, are moving in parallel. There's a little more approval processes needed in tax stamps than there is in the pharma and the foil, and so I would imagine that foil would be one of the things that comes on first and tax stamps follow on it. There is a cycle in the way you do things. We're plugged into those queues and we'll be bringing everybody the news of those as they happen. We're trying to do it as things happen now, as opposed to forecasting because one of the things that we've found in government or in this business is it shifts from quarter to quarter as you get an indication now that they want the product, you quote it, you do it, you get it ready and then they go, "We don't want it until next quarter," and we've come out and said things. In the case of these things now, what we're saying is once that we start production on them, we will make an announcement on that.

Pardeep Sangha:

Okay. All right. Thanks, again, guys.

Doug Blakeway:

Okay. Thanks, Pardeep.

Troy Bullock:

Thanks, Pardeep.

Operator:

Once again, that is star, one for any further questions. Mr. Blakeway, I would like to turn things back to you for closing remarks.

Doug Blakeway:

Okay. Thank you, Kelly Ann. I'd like to thank everyone for your questions and for joining our third quarter 2018 conference call. We're pleased with the financial results and growth initiatives that we've put into place and we'll continue to advance these in the coming months. We look forward to updating you on our continued growth path at our next quarter conference call.

I'll now turn the call over to the Operator for closing details. Kelly Ann?

Operator:

Thank you. This concludes Nanotech Security's third quarter 2018 conference. A replay of this call is available at 1-844-512-2921 for callers in Canada and the U.S until September 9, 2018. The pin number to access this call is 9106914. Thank you, all, and goodbye.