



Nanotech Security Corp.

First Quarter 2019 Results Conference Call

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

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Troy Bullock, *President 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*

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Gianluca Tucci, *Echelon Wealth Partners*

Grant Caudwell, *Haywood Securities*

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

Operator:

Good afternoon, everyone, and thank you for joining us to discuss Nanotech Security Corp.'s first quarter 2019 results. On the call today we have Troy Bullock, Nanotech's President and CEO, and Monika Russell, Nanotech's acting CFO. At this time, all participants are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session, and instructions will be provided at that time. Today's conference is being recorded.

At this time, I would like to turn things over to Monika Russell. Please go ahead.

Monika Russell:

Good afternoon and thank you for attending our First Quarter 2019 Conference Call. Troy Bullock will begin the call today with an overview of our Q1 results and operational highlights. I will then provide a detailed review of our financial performance for the quarter. Following the financial review, Troy will provide an outlook and a discussion of our goals and expectations for Fiscal 2019. 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 our forward-looking statements. For caveats about forward-looking statements and risk factors, please see our MD&A for the year ended September 30, 2018, which can be found on our Company profile at sedar.com.

Also, as part of the Company's business involves dealing with security features for banknotes, you will 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 that we are 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 as security features on banknotes.

I will now pass the call over to Troy for an overview of our first quarter. Troy?

Troy Bullock:

Thanks, Monika, and good afternoon, everyone. Thank you for taking the time to attend our conference call for the first quarter of fiscal 2019. Our first quarter ended December 31, 2018 was a mixed quarter for the Company.

Although we saw revenue decline by 21% year-over-year to \$1.7 million, I am pleased to announce that we did achieve positive Adjusted EBITDA again this quarter, our seventh consecutive quarter of positive Adjusted EBITDA. Gross margin remained strong at 70%, and we ended the quarter with a very solid cash position of \$10.9 million, and financially, the Company remains strong.

I want to remind investors that the decline in revenue in Q1 was not due to lost contracts or issues with our technology. On both fronts, we believe we remain very well positioned. Given the Company generates most of its revenue from development contracts with a single banknote customer, the weaker revenue this past quarter was, as expected, due to the timing and scope of the contracts in the quarter. The Company will continue to generate most of its 2019 revenue from development contracts with this customer.

While we are getting closer to reaching the goal of incorporating a Nanotech security feature on the customer's banknote, advancement towards this goal corresponds with the customer narrowing the scope of development activities with an intention to select a final security feature. This selection could see us move to manufacturing production volumes in fiscal 2020.

While focusing on a single security feature is a positive development, the scope of work has been reduced and overall 2019 revenues may be negatively impacted. We continue to operate under an agreement to provide up to \$30 million in research and development services, and as of December 31, 2018, only \$12 million of this revenue has been recognized.

On the year-end call in December, we also announced an executive succession plan, with Doug Blakeway moving from being CEO of the Company to Chairman of the Board and myself moving from being the CFO to becoming CEO of the Company. Monika Russell moved into the acting CFO role from her past role as Vice President of Finance.

The transition is now complete, and we have all been in our new roles for the last eight weeks. While it is still early, I can say that we have all been extremely busy, and the Company is enthusiastic about the future growth prospects for the Company.

One of my first achievements in the new role was to add Brian Donnelly to the executive team as Vice President of Sales. Brian is a seasoned successful sales executive with experience selling into international governments. Brian's mandate is to put formal processes in place and to build out both the banknote and commercial sales initiatives for the Company. I am happy to announce that in the last six weeks since Brian has been aboard, we are already making very good progress towards these goals.

Together, we have already made significant changes to our approach to sales. These changes have included introducing a more structured sales process that will force us to be more disciplined in qualifying opportunities with a focus of building out a sales pipeline and scaling our business.

We will also focus on developing deeper relationships with established players in both the banknote and commercial market. Brian and I will be hitting the road in the next several weeks and will go and visit several of our partners as well as existing and new customers.

The Company also recently announced a new slate of directors to be voted on at the AGM in April. This new slate includes three new directors: Hoch Cho, Neil McDonnell, and Ronan McGrath. These new Board members will add strategic leadership, commercialization, marketing expertise to help guide Nanotech through its next phase of growth.

The new Board will be rounded out with some of our existing directors: Doug Blakeway, Bernie Zinkhofer, and Bozena Kaminska. I have also joined the Board in conjunction with the January 2 executive succession plan.

This concludes my initial comments on the first quarter of fiscal 2019, and I will now pass the call back to Monika to discuss the detailed financial results for the quarter. Monika?

Monika Russell:

Thank you, Troy. Before I begin, I would like to mention that all the dollar amounts I refer to are in Canadian dollars unless otherwise stated. I would also like to highlight that our comparative figures have been adjusted to reclassify tenant income from revenue to other income, which was due to the adoption of IFRS 15 at the beginning of fiscal 2019. A full discussion of the new accounting standards adopted can be found in Note 3 of the financial statement.

I will start out the discussion of our quarterly results with revenue. Q1 revenue was \$1.7 million, which was down 21% from the first quarter of fiscal 2018. This decrease was primarily due to the timing and scope of development contracts.

Gross margin for the first quarter was 70%, which was 4 points lower than the first quarter of 2018 due to a lower proportion of development contract revenue in our revenue mix. Our operating costs for the first quarter of 2019 were \$850,000 higher than the same period last year. This increase was mostly due to a one-time restructuring cost triggered during the transition of our former CEO, Doug Blakeway, to his Chairman role.

Net loss for the first quarter of 2019 was \$1.1 million versus net income of \$96,000 in the first quarter of 2018. The difference was primarily due to the aforementioned restructuring costs. Adjusted EBITDA for the first quarter of 2019 was \$118,000 compared to \$460,000 in the same period of 2018. The difference is primarily due to decreased revenue in the current quarter. As Troy mentioned, this was our seventh consecutive quarter of positive Adjusted EBITDA.

The Company remains debt free, and we ended the quarter with a strong liquidity position of \$10.9 million, an increase from the \$9.6 million reported at September 30, 2018. Our operations generated cash of \$1.3 million, and we made capital investments of \$8,000 during the quarter. We also invested excess cash of \$25,000 in term deposits, which are shown in short-term investments on our balance sheet to generate additional interest income.

This concludes my comments on our results for the first quarter. I will now turn the call back to Troy to provide an update on our outlook for 2019. Troy?

Troy Bullock:

Thanks, Monika. It has only been two months since our year-end call where we outlined Nanotech's 2019 strategy. That said, I do want to remind everyone of our strategic goals for the rest of fiscal 2019 and update you where I can. The primary focus of our 2019 strategy is to invest in sales and marketing initiatives that will lay the groundwork to commercialize our technology and position us for further revenue growth in both the banknote and commercial markets.

My first priority was to establish a sales force to strengthen and accelerate the sales process by focusing on direct sales in addition to working with strategic partners. The Company will also put in place a more scalable sales process that will focus on diversifying our customer base and demonstrating our competitive advantage through banknote and commercial product lines. In doing so, we will develop a more traditional sales pipeline with defined products targeted at both small and large customers by creating the necessary production, supply chain, channel development strategies required.

Six weeks ago, we announced Brian as the Vice President of Sales, and together, we have already made significant changes to our sales processes. In addition, Brian and Igi LeRoux have already made several North American and international customer visits to demonstrate our technology and begin qualifying new opportunities.

In the banknote market, we have two areas of focus: contract development activities and creating dedicated banknote product lines. Currently, we generate most of our revenue from development contracts with a single customer with the goal of incorporating a Nanotech Security feature on their banknote. This work continues to progress very well, and the customer has narrowed the scope of their development activities, which could see us move to manufacturing production level volumes in fiscal 2020.

We also plan to brand our current unbranded products, such as optical thin-film, and extend our banknote product line with a new version of M2. We believe that by creating an exclusive banknote product line we will be able to showcase various applications for our technology in a manner that banknote customers can easily relate to. Each product will fit an already understood and demonstrated customer need in the banknote market. Since January, we have already made progress in our transition to developing and branding our banknote products. We have established clear plans for 2019 to design a new exclusive banknote product and have begun to develop production and supply chain capabilities that can initially deliver these products through partners and eventually from our high-security Thurso production facility.

Moving on to the commercial markets, we plan to launch a new line of product offerings featuring our KolourOptik technology, which will be specifically targeted at commercial markets. We are also in the process of securing reliable and timely manufacturing solutions for commercial-sized quantities of KolourOptik labels. By implementing these strategies, we believe we will be able to sell directly to commercial customers and deliver complete authentication labels that will enable customers to showcase their brand identity. Again, we have made good progress since January, spending significant effort designing product offerings that take full advantage of our unique KolourOptik technology, specifically for the commercial market. In addition, we have begun to build out a supply chain, including working with a North American production partner, to enable us to deliver commercial volumes. We are planning to have a product launch within the next couple of months.

Finally, we want to improve how we demonstrate our products and technology. We have found that both potential customers and potential shareholders appreciate help in visualizing how our products fit into banknotes and commercial goods. We also have plans to enhance our web presence so that our customers and investors can see how our products compare to the competition. I want to reiterate our confidence in the sophistication and uniqueness of the technology and the significant revenue potential it

has across many markets. We are confident that KolourOptik products and our development contracts are on track for a successful incorporation of a revolutionary security feature onto banknotes, which could well lead to long-term recurring revenue.

Diversification into commercial markets is also expected to help stabilize revenues and earnings. However, in the short term, while management builds out its sales strategy and product offerings, the Company's financial performance may be variable. Our fiscal 2019 guidance remains unchanged.

Management is forecasting the following for fiscal 2019: Based on our current visibility and conservatively assuming no additional contracts that would be won during the year, revenue may decline by 10% to 20% compared to 2018.

The Company will continue to generate most of our 2019 revenue from development contracts with our principal customer. As I mentioned earlier, the work is progressing very well, but the scope of work has been reduced, so overall, 2019 revenues may be somewhat negatively impacted. We are still forecasting an Adjusted EBITDA loss of approximately \$1 million for 2019. Potential declining revenues and an increased investment in expanding sales efforts and product offerings are anticipated to reduce near-term profitability.

Looking into the future, Nanotech has the opportunity to transform the world of print with KolourOptik nano-graphic display technology. KolourOptik offers unprecedented live content, visual effects, and high-fidelity colours that redefine the conventional print image. As we advance commercialization, we are well-positioned with our secure production facility to deliver highly differentiated products to both the banknote and commercial markets. It has been a busy couple of months and the whole team is very excited and confident with the current positioning in the market. We have a highly differentiated technology, and we are poised to add the products, delivery, and sales resources to capitalize on it. We are already well into the advancement of our commercialization strategies, so 2019 should be a year of exciting developments.

With that said, I will pass the call back to the Operator to open the call up for questions.

Operator:

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

We will hear first today from Pardeep Sangha with Haywood Securities.

Pardeep Sangha:

Hi, good afternoon.

Troy Bullock:

Hi, Pardeep.

Pardeep Sangha:

I just want to get a better feel for the development contract. Right now, as you said, you think \$12 million of that contract has been already executed on of the \$30 million. Trying to understand if the contract goes into production in 2020, what happens to that contract? And what if you don't get into production in 2020, what happens to that contract? In both situations.

Troy Bullock:

Yes. Thanks, Pardeep. I would describe the contract as a blanket contract from which we draw on each year or even midway through the year as we make applications to the customer to take on various new projects.

As an example of that, over the last couple of years, we have typically had between two and three different projects underway, each of which would be drawing down from that \$30 million so-called approved budget, if you will. As we advance going forward, we have been told by the customers that there are really two ways that we are going to continue to work with them.

One way is we are going to continue to do research and development work for them, not just to complete this security feature that we are hopeful that will move into the next phase and work onto their banknote, but they have also expressed interest that they'd like us to continue to do new security feature development work for them. I can see that R&D type work continuing on.

Where we believe that we are at as far as the R&D work we have done to date is last fall, September timeframe, the customer had asked us to sort of narrow the scope of the development work, and they wanted to get to a stage where they have actually selected now the type of technology, the type of security feature that they want to put forward to go onto their banknote.

Our challenge for this year is that they now have selected that. So, they want to now move us into more of a production testing phase, if you will, where we are going to be demonstrating the ability to show higher volumes and that we can meet some of the critical requirements that they need to qualify as a production-ready security feature as opposed to a design security feature.

That is the next stage that we would like to get into with them that they have told us that they would like to move us into. Once we get to that stage, we would agree on a cost for that over a 12-month period, and that again would fall under this budget of the \$30 million contract. If it didn't happen that way, we would likely just continue to work on development R&D work to further it along to a stage where it is ready to move into that next phase of production testing.

Pardeep Sangha:

Okay. With regards to that going into production, at what stage do we kind of say you've got a design win? Or how do we characterize this? Or what are the kind of milestones we can be expecting over the next couple quarters? Is there a trial run or some sort of limited production capacity run or design win of some sort? Or some sort of negotiation that needs to be done? Or give us a sense of what we should be looking for the rest of the year.

Troy Bullock:

Yes, again, good question. The next major milestone that we are looking for is to move into that next phase of I'll call it production testing. I am trying to not use the actual terms because of confidentiality for the government process, but we'll move into a production testing. We are hoping that we can do that within this fiscal year, within fiscal 2019. So, sometime between now and September.

The expectation from that would be that once we are in that, that is typically about a 12-month period. And so, during that period of fiscal 2020, we would then be running more production-level samples, higher-volume samples, to demonstrate an ability to produce the security feature in higher volumes. That would sort of be that next phase. I think the phase after that would be in 2020 is to have them say, yes, we are comfortable that you can produce it in higher volumes. Now we are ready to start to integrate it

into our banknote process and begin again to accept further samples and further volumes as they narrow in the scope of the actual physical design of the feature.

Pardeep Sangha:

Okay, that's helpful. Then a question here is around the tax stamp opportunity in India. You didn't mention anything about that today.

Troy Bullock:

Yes, I haven't, Pardeep, and I will be upfront about that. That is something that I haven't made as much progress on in the first eight weeks that I would like to have. What I've seen to this point—and what I said previously in the last call—was that I wanted to get a really good understanding myself before I started setting more milestones for that customer and that opportunity. That would involve me meeting with them face to face, but at the same time understanding what their pipeline of opportunities looks like. What we have done in the last eight weeks is I've had them send over to us a package of information that they are using as their marketing materials to promote to their customer base. We frankly just received this a couple days ago.

It is actually a fairly impressive looking package. They have sent over four bound books of KolourOptik nanotechnology security features that describes—the one book goes on to describe in length the benefits of KolourOptik over traditional holograms, and why it is a better solution. And then it's got a second and third book that are full of different samples that they have created within their factory, using our shims but produced in their factory to demonstrate the technology. I've got a pretty good sense of the sales materials that they are using. But really, for us to advance that and have more visibility, really our next stage for us is we would like to have more visibility into how they are building out their pipeline. I would like to have weekly interactions with them, so we understand who they are calling on, what the customer opportunity is, who the competition is.

And as opposed to just looking at it as India and the tax stamp opportunity, I want to know how many people a week they are talking to, and what their success rate is, and how we can help them be more successful over there. We need to spend more time with them. We need to invest more time with them. I am pleased to see what they are doing on a marketing side. I was quite excited to see the brochures that they put together and an investment in dollars they put together. But I really need to get to that next stage, and Brian and Igi are going to help get to a stage where we are more actively involved in the pursuit of their wins.

Pardeep Sangha:

And this is for both Holostik and Kumbhat or just one?

Troy Bullock:

It is for both of them. The books that I have—I will be clear, they were Kumbhat books, but I understand Holostik has done the same. They are both hologram manufacturing facilities that are operating in India. They are friends. They have relationships, and so they do try and partner on things, but they are absolutely arm's-length parties from one another. We have spent more time with Kumbhat to this point, but I want to see the same marketing material and understand the same sales approach with Holostik as well.

Pardeep Sangha:

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

Troy Bullock:

Okay. Thanks, Pardeep.

Operator:

We will hear next from Ben Jekic with GMP Securities.

Ben Jekic:

Good afternoon. Just a couple of questions. Troy, I think you were saying you are looking to add more production capability for the banknote side of the business. Is that going to involve some extra capex, and if so, how much? For this year.

Troy Bullock:

Hi, Ben. Thanks for the question. Yes, it will. One of the things that we are planning ahead for is that in anticipation of moving to that next level with the development contract customer, we need to be able to demonstrate that we have the ability to produce a completed security feature in volumes within our facility, our secure production facility in Thurso.

For us to do that, there is a couple of things that we need to do. One is we need to—we have got a very large building. It is a 100,000-square-foot building, as you know; I know you have been out to see it. Some of it we rent out to another party, but there is a fairly significant portion of it that we are not occupying right now, but obviously we still own and we still have access to. One of the first things is for us to kind of knock out a wall and expand into that area and ensure it is a secure area of the building. That is one area of focus for us.

Then we need to bring in three or four pieces of equipment that we will utilize to add more capability for us to make that security feature. Instead of just preparing the shim that we do here in Vancouver but actually then going to the next level of having the ability to recombine it, cast it, add the metal and ultimately an adhesive, and turning it into a full security feature—I won't go through all the various steps of that. But to add to those extra pieces of equipment, we are talking in the neighbourhood, or we are planning in the neighbourhood of about \$0.5 million of capital cost for this fiscal year. We are still expecting and hoping that our customer partner will help fund some of those costs as well.

Certainly, things like our building expansion and other areas we are going to have to pick that up on our own. But we are trying to work within a budget of about \$0.5 million. And we are hopeful that we can have all of this stuff complete by the end of this fiscal year, by the end of September.

It's a fair amount of work to do, both in the renovations to the facility and sourcing and putting the equipment in, but it will help us tremendously in having the ability to actually produce a product. So, whether when we are meeting with a banknote customer, whether it is on this development contract side or a future banknote customer, we have the ability to not only show them a security feature, but also commit that we could produce it for them and deliver that to them in volumes.

Ben Jekic:

Okay. My next question is—probably the second and third question are going to be the same, but just sort of specifically referring to the commercial side and the banking side. So commercial side then. Let's sort of leave India aside. When you are talking to potential customers, what is the general sense of your applicability to their business plan? Is it like okay, but there are five other competitors doing similar things? Or is it we will think about it and we will call you in three months? What is your sense? How far are you from kind of a more substantial take-up of these offerings that you have for the commercial market?

Troy Bullock:

Yes, thanks, and there's a couple different facets to that. What we have been doing to this point, and we will continue to do, is one sort of avenue for the commercial sales model. Then there is a second avenue which results in products and the ability to deliver a solution in a short period of time. And I will talk about each of them.

Going down the, I would call it, the partnering approach, we have been meeting with—and have done so over the last number of years but we will continue to do so—meeting with larger players in the marketplace with the intent of demonstrating them the unique features of our KolourOptik technology. Showing them how it's got the ability to produce movement and depth and high vivid colours and how it really differentiates from the traditional holograms or other products that have been shown out in the marketplace.

We are going in demonstrating a rich new technology that is quite unique. And we tend to be targeting that at really two different groups. One group that's producing security features, responsible for ensuring the authenticity of the products. They are traditionally buying security features, security labels that might be consisting of things like holograms or things that are currently in the market. And really, we are having those conversations with them as a replacement security feature and focusing on what we could do different or better than what they are currently purchasing, with the aim to developing something that would be unique for them. And then when successful, we would go down a path of filling out a supply chain and figuring out what that ultimate solution looked like.

We are also meeting with the brand enhancement people, the marketing people. These people are very much interested, less on the security side, but they are interested in differentiating their product on the shelf and differentiating how they could sell more widgets, if you will, by having something that is unique. I think in that space, our product shows off very well. Those kind of conversations are happening. The competition, if you will, would be traditional holograms or other security features. That is really more of a partnering model, if you will. I think it is still an important way that we need to move forward. But it is likely, or it is a longer sales cycle and it likely needs to result in working with a partner of a significant size.

What we are also adding to that sales process now is we are developing specific product design for the commercial market. We are going to have a product that has specific features to it. There will be two examples of it; we are pretty close to finalizing what those would look like. But there will be two examples of it. We can walk into a customer and say look, this is what we can make. It will involve your logo; it will do something specific that I will have to let you wait and see once we announce the product, but here is what that logo is, and then provide us your imagery, provide us your logo, provide us your tagline, provide us whatever it is on your business, and we can then tell you what the cost is for a security feature, and we will be in a position where within four to five weeks we can deliver your product.

To be able to do that, we have to define a specific product, not an open-ended we will design something unique for you, but specifically design what we can do, and what we can't do. Prepare the sales materials,

update the website, and build in the supply chain so that when I get an order, I have the ability to deliver a product to them within a very short period of time to a North American partner.

And that is the stuff that we are working on now. And I believe I did say during the formal portion of this conference call that we expect to have that product launched within the next two months. That means not just designing a security feature, but having the supply chain in place, having the sales tools in place, and putting a sales campaign around that so we can actually go into a customer with a finished product, with an intent to make sales, and turn that into—start to build out a sales pipeline.

Ben Jekic:

Thank you. That is very, very helpful. I wanted to ask a similar question on the banking side especially. I think I read that you mentioned the product that you launched last year in Dallas, that you are doing some modification for that to sort of create a product line. Can you elaborate on that a little bit?

Troy Bullock:

Yes. It's actually the same sort of approach and, again, two-pronged approach. On the one hand, we have developed some great relationships with some industry-leading players in the marketplace: De La Rue and Crane and Hueck Folien. And I mean, these are the dominant players in the space, and we are very fortunate that we have created such good relationships with them.

We want to continue to try and grow business for both of us in those relationships, developing deeper, further partnerships, and perhaps putting together unique security features that will help both parties grow in the future. That partnering strategy is still very much there and something we are going to pursue.

But at the same time, we also want to have a product strategy around it as well. We did come out with our first ever banknote product last year; we called it M2. It was launched last spring. We have been working with that product and gaining a whole bunch of feedback from customers, customers being central banks around the world, over the last year, and we have got a pretty good sense of the feedback that they have given us as to how we can take that security feature to a different level. How we can take that to something that will be highly differentiated from what is currently out there in the marketplace and design that as a security feature.

We are going through that process right now. And again, within the first half of this year, so sort of targeting the June maybe into July type timeframe, we hope to launch a new security feature specifically for the banknote space. This will be exclusively for the banknote space; we would not be selling this into the commercial market because of a number of competitive and security reasons.

But we want to have that product. We want to have the ability to take orders and have the ability to produce it. And it likely will be produced with a partner in the near term. But once we do the renovations and the things that I talked about for our Thurso facility, eventually we will have the ability to produce that product in-house. We could go into a central bank, show them the product, get them excited about that, and be in a position where we could take orders and deliver them billions of security features all produced within house.

Ben Jekic:

That's great. Thank you very much.

Troy Bullock:

Thanks, Ben.

Operator:

Again, that is star, one for questions at this time.

We will hear next from Gianluca Tucci with Echelon Wealth Partners.

Gianluca Tucci:

Hi, Troy. Just a question on Hueck Folien. Can you drive a bit deeper as to how your talks have progressed over the past quarter in terms of pursuing other volume and licensing opportunities with Hueck Folien?

Troy Bullock:

Yes. Since the last call about eight weeks ago—not a lot has changed there. I think from sort of a partner relationship, we have been quite pleased with the quality of what we have seen out of Hueck Folien as far as their ability to produce a colour-shifting foil.

Now, as we have described in the past, Hueck Folien is one of the leaders in the banknote market. They enjoy a very good reputation. They have been delivering security features to this market for decades and have their own product offering and a number of other avenues and partnerships that they have in place. And so, we are really excited to call them a partner and excited to continue to work with them.

The challenge we have had over the last couple of years was taking on a really difficult challenge of producing a colour-shifting film specifically targeted and looked at for China. I think through that process, we had some struggles, they had some struggles, in trying to get to a point where they could produce it at a quality level that worked for that particular arrangement.

And I think to a large extent, we have moved on from that particular customer. But we have got to a stage where we are very happy with the quality of what they are producing. We have recently looked at it in the last, I'd say five weeks and the quality is quite good.

And our quality team out of our Thurso facility, which I would argue are the world experts in producing optical thin-film, colour-shifting optical thin-film, as they have been doing it for some of these guys for 25 years, they have looked at that quality and said it is at a high quality now. That our partner is so-called qualified; they are producing good quality product. That has been the primary focus for us: getting that quality up to a level where both sides, both Hueck Folien and ourselves, are happy with their quality. And I think we have achieved that.

Our next challenge now is to begin to work with them to pursue colour-shifting film opportunities around the world. And there are several out there, and that is the stage we are at right now. I can't say there is a list of 10 or 15 of them that we are working on, but there are some things that we are starting to talk about and customers that we are starting to pursue. And I do think there is opportunities out there for volume colour-shifting optical thin-film with our Hueck Folien partner.

At the same time, I am also excited about the colour-shifting film opportunities that we could produce out of our Thurso facility. Historically, we have done traditionally about \$1 million of optical thin-film produced out of our Thurso facility. We see that as something that there is tremendous opportunity in the near term.

I mean, I think even within fiscal 2019, where we could pursue new business and start to see our optical thin-film business generate and contribute more revenue to the business.

Gianluca Tucci:

No, that's great colour. Thank you, Troy. In terms of your sales force rejigging, how far—or if I put it in baseball terms, what inning of the game are you at internally in terms of rejigging, retraining, refocusing your sales force?

Troy Bullock:

Yes, I'm reluctant to give you an inning. Obviously, Brian has been here for six weeks, so we are six weeks into making some changes to our approach to selling a product as opposed to trying to develop business with a partner, which has probably been the approach that we have been taking for the last number of years because that is where we were at as far as technology development.

That said, we have brought in an experienced sales professional. It is not bringing in somebody that has to learn how to sell and learn how to develop a sales channel and things like that. We have got somebody with 25 years of international sales experience accustomed to selling into commercial and government markets. So, we've brought somebody in that knows what they are doing. And the focus of what we have done over the last six weeks, because it has been a fairly significant amount of my focus, certainly of Brian's focus and Igi's focus as well, is we have developed a more rigorous traditional sales process. A traditional pipeline as to how do we qualify opportunities so we are not spending a lot of time on customer opportunities or leads that may not lead somewhere. Because they are not really qualified; they are not really interested; they are not ready to make a buying decision.

We are working our way through or we have developed more of a structured process that we know who to target, how do we ask the right questions, how do we get to the right people in the organization so that we can make some early-on decisions, so we don't have to spend months and quarters and years chasing something that may never actually be somebody that was really interested. They were just curious about the technology. So, we have structured this process, which is customized to our business, and I think it is quite good. At the same time now, we are already have been out within that six weeks. Both Brian and Igi have done an international trip and have done a North American trip and have met a number of different customers.

I think the next stage that we need is when we go into these customer meetings, we need more materials. We need products to show them. We need samples to leave behind. We need to be able to flood the market with examples of what we actually can do as an organization, products that we can produce. So that we can demonstrate to the buyers or the people that are interested what our product offering is and why it is differentiated from what is out there. As you know, and people that have seen our product, one of the big differentiators is the visual impact that you see from it. We have to be at a stage where we have samples, thousands of samples, where we can walk into a meeting and leave a stack of 10 samples on the table, so they can share it with everybody in their organization and generate that excitement.

It's not just as simple as hiring a salesperson and developing a process. We need the tools, the products need to be developed, the sales tools need to be developed, the website needs to be updated. The content on the website explaining the use cases, explaining customer wins, and why it was successful for the UEFA ticket, and what benefits that they had. And so just as we move from a start-up into a more commercialized Company, these are just kind of the natural things that we need to put in place as we commercialize our product. Early stages of the ballgame, if you will, but a lot of experienced people around that are extremely passionate, excited to put this stuff in place quite quickly.

Gianluca Tucci:

Okay. Yes, thanks, Troy. Two modelling questions here. You booked about \$800,000 in restructuring. Can you elaborate on that? And if there is anything to be booked in Q2 to Q4 on the restructuring side?

Troy Bullock:

Yes. The restructuring cost relates exclusively to the transition and termination of Doug's agreement, the prior CEO's agreement. We are not expecting any further costs in that area. That number does also include a contingent amount through the transition. In fact, it actually could be a lesser amount. We could even see a small recovery on that depending on how the year unfolds. But that definitely is a one-time charge. We are not anticipating any future charges like that in the foreseeable future.

Gianluca Tucci:

Okay. Then just on the gross margin side, is it safe to assume a rebound in Q2 from Q1? I would assume that in the second quarter there is a bit more R&D work to be done, so that should provide an uplift on margins, if I am correct.

Troy Bullock:

Yes, it's difficult to forecast out with a level of precision on our margins. If you have looked at the last year, they fluctuated from 70% to 80%. They typically have been in that range. Maybe that average is closer to 75% or slightly the high 70%. It is heavily influenced by the mix of products that we sell and the customer relationship for the customers that we are talking to on a quarter-by-quarter basis. It's just sort of an assumption you will have to make on mix, depending on whether you are modelling in that we will be more successful with optical thin-film or whether we will be more successful expanding the scope of work on our development contracts.

But I think if we look back over the last six or seven quarters, it has traditionally been in that 73% to 80% range. Based on history, that's probably a good mix going forward that we are sort of targeting, but it is heavily dependent on our revenue mix.

Gianluca Tucci:

Okay, thanks, guys. Appreciate it.

Troy Bullock:

Okay. Thanks, Gianluca.

Operator

We will hear next from Grant Caudwell with Haywood Securities.

Grant Caudwell:

Good day, Troy.

Troy Bullock:

Hey, Grant. How are you?

Grant Caudwell:

Very well. Thanks. Just two quick questions to throw at you. First question is just on the—in the news release today, you indicated that you are looking at going after a new version of M2 for an extended product line. Could you just elaborate on that a little bit more?

Troy Bullock:

Yes. M2 is our first product that we came out last year targeted specifically for the banknote space. And first of all, just to clarify, the reason why we want to have unique products for the banknote space compared to or exclusive from the commercial space is it is very important to a banknote customer that when they buy a security feature, or they consider a security feature, they want to make sure that it is not going to be something that they can go and find on a commercial product, a Corn Flakes box or something else. Because this is their country's currency. They need to have confidence that this is a security feature that is not readily available in the marketplace. It is important for us to differentiate our offerings, both our technology and our product offerings, to have exclusive products that are targeted at only the banknote space. We can have separate products for the commercial space, but we can't share them back and forth.

The M2 product series was our first launch to come out last year—I guess about a year ago we launched for that space. We've received over the past year a tremendous amount of feedback on that product. It was largely launched as our beta product to gain feedback from central banks as to what do they like about it, what do they not like about it. Some of the feedback that we received were things like they really were attracted to the border around the edges and the movement and the fact that we could use multiple colours in the design of that.

And so, we have been gathering that information over the past year. Now we are at a stage where our goal is to come out with a new product. It's not just design a new feature—it takes all the latest technology that we have gathered over the past year, but the input from the central banks to design a unique security feature specifically for the banknote community, and then have all the other materials to go with it. It is not just designing an image, but it is having the sales materials, having the product samples, having thousands of samples, so when we go to visit a central bank, we can leave them with 15 or 20 samples so they can share them around and promote them within their own government.

But then also building out the supply chain, so that when we are fortunate enough that we can walk in and show the sample that the customer says I'm very much interested in that, we'd like to buy 500 million of these, that we have the supply chain in place. Initially for the banknote space, this will be a third-party solution, but eventually we will be at a point, once we have renovated our Thurso facility, to produce that product in-house. It's actually quite a transition for the organization to go from talking about a technology and talking about what we could do with it into actually having a finished commercialized product with the supply chain and the delivery channels in place to deliver it with confidence in a high-secure environment to a specific market like the banknote space.

Grant Caudwell:

Are you saying that the next M version will be that product?

Troy Bullock:

That is right, Grant. We haven't named it yet, or we haven't announced the name of it. We have got a few names internally that we are still throwing around. But it will be the next version of the M2, if you will, and

probably has a different name targeted specifically at the banknote space with all the supply chain and the product materials and all of that. That will be the product offering, the launch, if you will.

We are targeting doing that within the first seven months of this year. The sort of June, July timeframe is where we are targeting having that information and product released.

Grant Caudwell:

Thanks for that information. The just second question is in the release, you also mentioned based on current visibility and conservatively assuming no additional contracts, maybe one during the year, your revenue will decrease. Can you give us any flavour on are we actually doing any development work or preliminary work on contracts that may, even though they are not in your numbers, may actually appear in 2019? If those are (inaudible) one?

Troy Bullock:

Yes. The variability into our projections, if you will, or our forecasts for this year is obviously we have got some development work currently in place that we are working on with our government contract. In addition to that, we have enjoyed, over the last number of years, some recurring optical thin-film orders that—it's not a contractual arrangement, but typically every year we've received a purchase order for the summer delivery of some optical thin-film.

We don't have those orders in hand, but we've had them in each of the last few years. We are planning for them. We still have to do our work, our sales efforts to continue to ensure we win that business. Those activities are continuing on. If we are successful with the visibility that we have, we will certainly be within that revenue range and guidance that we forecasted.

For us to go beyond that, for us to see some growth or get back to where we were last year, there are a couple of things that we can do. One avenue is going to be to continue to grow and sell more optical thin-film. That is a product that we have today. We have the ability to make it. It is a product that customers are currently buying from other suppliers, other competitors. If we can go in and convince somebody to switch supply, you could literally have a sales call on a banknote customer next month and be delivering product to them in 60 days. That is something within this year we can, and we are, formulating sales strategies to go after central banks and customers to win their colour-shifting thin-film product. Because we've got the ability to produce that now, and it's product that's being purchased now from competitors. So, if we can be successful and win some of that, that will be accretive, if you will, to our revenue forecast.

The other one is obviously with our government contract. We have this preapproved, if you will, \$30 million budget. If we can expand the scope of that work, speed things up, get into the production testing stage earlier or at a more aggressive pace, that can also result in further revenue. Our ability to influence sort of near-term fiscal 2019 revenue is quite limited because we don't have necessarily the supply chains and the products launched already. All we are doing is talking about the technology.

Once we put the products in place, we can begin selling them and then late-late in the year we could start to influence revenue from the product standpoint. But the things that can influence it that we have today are to some extent limited to our thin-film that we can produce today and in expanding our development contract with our large customer.

Grant Caudwell:

Okay. Well, thanks. That's it for me.

Troy Bullock:

Thank you, Grant.

Operator

This will conclude today's Nanotech Security's First Quarter Conference Call. A replay of this call is available at 844-512-2921 for callers in Canada and the U.S. The PIN number to access this call will be 265362. Again, we thank you all for joining us, and you may now disconnect at this time.