NANOTECH

December 31, 2019

QUARTERLY REPORT

For purposes of this management's discussion and analysis ("MD&A"), "Nanotech", the "Company", "we", or "us" refers to Nanotech Security Corp. This quarter or the current quarter means the three months ended December 31, 2019.

ADVISORY

This MD&A, dated February 12, 2020, should be read in conjunction with the cautionary statement regarding forward-looking statements below and the Company's condensed interim financial statements for the three months ended December 31, 2019 as well as with the Company's consolidated financial statements and MD&A for the year ended September 30, 2019. The results reported herein have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") and are presented in Canadian dollars. All quarterly information disclosed in this MD&A is unaudited.

Additional information relating to the Company is filed on SEDAR at www.sedar.com.

FORWARD-LOOKING STATEMENTS

The following discussion and analysis of the financial conditions and results of operations contains forward-looking statements concerning anticipated developments in the Company's operations in future periods, the adequacy of Nanotech's financial resources, and the events or conditions that may occur in the future. Forward-looking statements are frequently, but not always, identified by words such as "expects", "anticipates", "believes", "intends", "estimates", "predicts", "potential", "targeted", "plans", "possible" and similar expressions, or statements that events, conditions, or results "will", "may", "could" or "should" occur or be achieved.

These forward-looking statements include, without limitation, statements about the Company's market opportunities, strategies, competition, and the Company's views that its optics-based technologies will continue to show promise for large scale production. Other forward-looking statements imply that the Company will remain capable of being financed and/or will be able to partner development until profitability is eventually realized. The principal risks related to these forward-looking statements are the loss of a key customer, that the Company's products receive market acceptance and that its intellectual property claims will be sufficiently broad or enforceable to provide the necessary protection or attract the necessary capital.

These forward-looking statements are based on the beliefs, expectations and opinions of management on the date the statements are made. Consequently, all forward-looking statements made in this discussion and analysis of the financial conditions and results of operations or the documents incorporated by reference, are qualified by this cautionary statement and there can be no certainty that actual results or developments the Company anticipates will be realized. For additional information with respect to certain of these risks or factors reference should be made to the "Business Risks and Uncertainties" section of the MD&A and the notes to the audited consolidated financial statements for the year ended September 30, 2019, as well as with the Company's continuous disclosure materials filed from time to time with Canadian securities regulatory authorities, which are available online at www.sedar.com. Nanotech disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than as required by law. Caution needs to be used when taking forward-looking statements into account when evaluating the Company.

GENERAL OVERVIEW

Nanotech is incorporated under the laws of British Columbia with common shares listed on the TSX Venture Exchange (trading symbol: NTS) and quoted in the United States on the OTCQX Market (trading symbol: NTSFF). The Company's head office is located at #505 - 3292 Production Way, Burnaby, BC, Canada V5A 4R4. In addition, the Company owns and operates a manufacturing facility located in Thurso, Quebec. The Company's registered and records office is #1200 - 200 Burrard Street, Vancouver, BC, Canada V7X 1T2.

Nanotech researches, creates, and produces nano-optic structures and colour-shifting materials used in authentication and brand protection applications across a wide range of markets including banknotes, secure government documents, and commercial branding. The Company's technology platforms include:

- KolourOptik® is a patented technology that is exclusive to the government and banknote market and combines sub-wavelength nanostructures and microstructures to create modern overt security features with a unique and customizable visual effect. KolourOptik pure plasmonic colour pixels produce full colour, 3D depth, and movement used in security stripes and threads that are nearly impossible to replicate.
- LiveOptik™ is a patented technology that utilizes innovative nano-optics one tenth the size of traditional holographic structures to create next generation overt security features customized to our customers' unique requirements. LiveOptik delivers multi-colour, 3D depth, movement and image switches for secure brand protection stripes, threads and labels that are nearly impossible to replicate.
- LumaChrome™ optical thin film security features are manufactured using precision engineered nanometer thick layers of metals and ceramics to form filters designed to uniquely manipulate visible and non-visible light. This unique manipulation of light properties is used to create specialized security features in the form of threads, stripes and patches that are applied to banknotes and other secure documents. By using sophisticated electron beam and sputtered deposition methods, Nanotech precisely controls the construction and inherent properties to provide custom tailored colour-shifting solutions. An individual looking at these threads, stripes and patches sees an obvious colour-shift (e.g. green to magenta) when it is tilted or rotated.

RESULTS OF OPERATIONS

Select financial information for the three months ended December 31, 2019 and 2018:

Select Financial Information	2019	2018[1]
Revenue	$ 1,469,926	$ 1,531,673
Cost of sales	305,809	361,548
	1,164,117	1,170,125
Expenses		
Research and development	401,932	336,111
General and administration	590,420	537,567
Sales and marketing	586,050	444,714
Depreciation and amortization	370,489	370,759
Restructuring costs	-	815,700
	1,948,891	2,504,851
Loss from operations before other income	(784,774)	(1,334,726)
Other income	(2,284)	(202,816)
Net loss	$ (782,490)	$ (1,131,910)
Adjusted EBITDA[2]	$ (260,463)	$ 117,631

[1]Results for the three months ended December 31, 2018 have been adjusted to reflect the full retrospective application of IFRS 15, which was adopted October 1, 2018. For further information, see note 2(a) of the condensed interim financial statements for the three months ended December 31, 2019.

[2]Adjusted EBITDA is a non-IFRS measure as described in the Non-IFRS Financial Measures section of this MD&A.

Revenue

The Company currently derives the majority of its revenue from contract services with a G10 central bank. During the year ended September 30, 2017, the Company disclosed a development contract for up to $30.0 million over a period of up to five years. These contract services incorporate both nano-optic and optical thin film technologies and are focused on developing authentication features for future banknotes. While the Company is progressing toward the goal of incorporating a Nanotech security feature on this customer's banknote, there is inherent variability in the timing and scope of contract services. Revenues from this customer declined by $251,673 or 17% in the three months periods ended December 31, 2019 compared to the same period last year.

Revenues for the three months ended December 31, 2019 decreased by $61,747 or 4% to $1,469,926, compared to $1,531,673 in the same period last year, due to lower contract services in the current period, partially offset by increased product sales. Product sales increased by $189,926 or 355% as the Company delivered eight product sales in the quarter, compared to just two in the same period last year.

Gross Margin

Gross margin for the three months ended December 31, 2019 decreased by $6,008 or 1% to $1,164,117, compared to $1,170,125 in the same period last year. The gross margin percentage was 79% for the three months ended December 31, 2019, up from 76% in the same period last year. This increase was primarily due to higher margins on contract services in the current quarter.

Research and Development

Research and development expenditures for the three months ended December 31, 2019 were $401,932 an increase of $65,821 or 20%, compared to $336,111 in the same period last year. This increase was primarily due to increased equipment maintenance costs and salary expense in the current period, partially offset by a write-down of inventory in the prior period.

General and Administration

General and administration expenditures for the three months ended December 31, 2019 were $590,420, an increase of $52,853 or 10% compared with $537,567 in the same period last year. The increase was primarily due to increased salary expense and professional fees in the current period, partially offset by reduced rent expense as the Company transitioned to new lease accounting under IFRS 16 – *Leases* ("IFRS 16") in the current period.

Sales and Marketing

Sales and marketing expenditures for the three months ended December 31, 2019 were $586,050, an increase of $141,336 or 32% compared with $444,714 in the same period last year. The increase was related to higher salaries and benefits expenses as well as increased conference and travel activity in the current period.

Depreciation and Amortization

Depreciation and amortization expenditures for the three months ended December 31, 2019 were $370,489, comparable to $370,759 in the same period last year, which reflects the additional depreciation recorded for right-of-use leased assets, in combination with reduced depreciation under the Company's declining balance depreciation method.

Restructuring Costs

On December 21, 2018, the Board implemented an executive transition plan, under which Mr. Doug Blakeway, the former CEO, transitioned his responsibilities to Mr. Troy Bullock. Under the terms of this transition plan, Mr. Blakeway's executive services consulting agreement was terminated, triggering termination benefits as laid out in the agreement: two years base salary, a pro-rated performance bonus, and vesting of all outstanding share-based awards. The Company incurred restructuring costs of $815,700 for the three month period ended December 31, 2018, of which $92,200 represented share-based compensation related to the accelerated vesting of Mr. Blakeway's restricted share units ("RSUs").

In January 2019, termination benefits were paid and 187,500 shares were issued to Mr. Blakeway upon vesting of his RSUs. Restructuring costs of $84,375 remain accrued as at December 31, 2019 (September 30, 2019 - $84,375).

Other Income

Other income for the three months ended December 31, 2019 was $2,284, a decrease of $200,532 compared to other income of $202,816 in the same period last year. The decrease was primarily due to a reduction in tenant and steam income, as the tenant renting warehouse space in the Company's Thurso facility filed for CCAA protection, resulting in a write down of certain tenant and steam receivables. In addition, other income decreased as a result of a foreign exchange loss in the current period compared to a foreign exchange gain in the prior period, due to higher fluctuations in foreign exchange rates in the same period last year. Interest expense recorded in the current period also increased as a result of the transition to new lease accounting under IFRS 16.

Adjusted EBITDA

Adjusted EBITDA for the three months ended December 31, 2019 was negative $260,463, compared to positive $117,631 during the same period last year. The decrease was primarily due to reduced revenue in the current period in combination with increased sales and marketing expenses and a reduction in other income.

Net Loss

Net loss for the three months ended December 31, 2019 was $782,490, compared to net loss of $1,131,910 during the same period last year. The decrease in net loss was primarily due to one time restructuring costs related to the executive transition in 2018, partially offset by higher operating costs and a reduction in other income in the current period.

QUARTERLY RESULTS

	Q1 2020	Q4 2019	Q3 2019	Q2 2019	Q1 2019	Q4 2018	Q3 2018	Q2 2018
($ thousands, except per share data)								
Revenue[(1)]	$1,470	$1,450	$1,827	$1,594	$1,532	$3,000	$1,769	$1,486
Net income (loss) from continuing operations	(782)	(705)	(521)	(477)	(1,132)	770	(456)	(333)
Net income (loss)	(782)	(705)	(521)	(477)	(1,132)	770	(627)	(285)
Adjusted EBITDA[(2)]	(260)	(299)	17	45	118	1,306	100	133
Basic earnings (loss) per share:								
Continuing operations	(0.01)	(0.01)	(0.01)	(0.01)	(0.02)	0.01	(0.01)	0.00
Net income (loss)	(0.01)	(0.01)	(0.01)	(0.01)	(0.02)	0.01	(0.01)	0.00
Diluted earnings (loss) per share:								
Continuing operations	(0.01)	(0.01)	(0.01)	(0.01)	(0.02)	0.01	(0.01)	0.00
Net income (loss)	(0.01)	(0.01)	(0.01)	(0.01)	(0.02)	0.01	(0.01)	0.00

[(1)]Reflects the full retrospective application of IFRS 15, which was adopted October 1, 2018. For further information, see note 2(a) of the condensed interim financial statements for the three months ended December 31, 2019.

[(2)]Adjusted EBITDA is a non-IFRS measure as described in the Non-IFRS Financial Measures section of this MD&A.

Revenue and Adjusted EBITDA were impacted by the timing and scope of contract services and the timing of recurring LumaChrome orders in the quarters presented. There is inherent variability in contract revenue with government organizations and in the receipt of recurring LumaChrome orders. Net income (loss) from continuing operations and net income (loss) were further affected by restructuring costs in the first quarter of 2019. There are no seasonal effects in the Company's business over the quarters presented.

RELATED PARTY TRANSACTIONS

For the three months ended December 31, 2019 and 2018, the Company had no transactions with related parties as defined in IAS 24 – *Related Party Disclosures*, except those pertaining to transactions with key management personnel in the ordinary course of their employment, or as disclosed below.

(a) *Remuneration of key management personnel*

	Three months ended December 31 2019	2018
Salaries, accrued bonuses, employee benefits and director fees	$ 193,944	$ 166,582
Share-based payments	79,241	102,852
Restructuring costs	-	815,700
	$ 273,185	$ 1,085,134

(b) As at December 31, 2019, amounts owing to a company controlled by a director of the Company included in accounts payable and accrued liabilities were $84,457 (September 30, 2019 - $90,938). These payables represent amounts owing upon the termination of an executive services consulting agreement.

(c) Legal and professional fees, taxes and disbursements totaling $nil for the three months ended December 31, 2019 (December 31, 2018 - $14,506) were incurred with a law firm of which a director of the Company is a partner.

The above transactions are in the normal course of business and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

LIQUIDITY AND CAPITAL RESOURCES

The Company's principal sources of liquidity are cash provided by operations, including collection of accounts receivable, and access to equity capital resources. The Company's primary short-term cash requirement is to fund any potential shortfall from operations, working capital, and capital expenditures. Cash is also used to finance other long-term strategic business initiatives.

Summary of Statements of Cash Flows

	Three months ended December 31	
	2019	2018
Cash provided by (used in) continuing operations	$ (559,563)	$ 1,293,647
Cash used in discontinued operations	-	(52)
Cash provided by (used in) operating activities	(559,563)	1,293,595
Cash used in investing activities	(258,705)	(50,476)
Cash used in financing activities	(34,730)	-
Effect of foreign exchange on cash and cash equivalents	19,514	27,591
Cash and cash equivalents, beginning of period	2,752,002	2,014,764
Cash and cash equivalents, end of period	$ 1,918,518	$ 3,285,474

Operating Activities

Cash used in operating activities was $559,563 for the three months ended December 31, 2019, compared to cash provided by operating activities of $1,293,595 for the same period last year. The increase in cash used in operating activities was primarily due to changes in non-cash working capital, offset by a decrease in net loss. Cash used in non-cash working capital increased from the prior year due to the timing of accounts receivable collections and payments of accounts payable.

In 2017, the directors of the Company made the determination to pursue the sale of its subsidiary, Tactical Technologies Inc. ("Tactical"), to a third party. Tactical was classified as a separate disposal group held for sale and as a discontinued operation. On June 29, 2018, the assets used in connection with Tactical's surveillance equipment and van conversion business were sold to an employee of Tactical for a nominal amount, and on September 28, 2018, Tactical was wound up and struck from the corporate register.

The cash flows for the period ended December 31, 2018 includes the effects of extinguishment of remaining liabilities pursuant to the disposal.

Investing Activities

Cash used in investing activities for the three months ended December 31, 2019 was $258,705, compared to $50,476 used in the same period last year. The increase in the current period represents increased acquisition of short-term investments and the expansion of the Thurso facility.

Financing Activities

Cash used in financing activities for the three months ended December 31, 2019 was $34,730, which represents the payment of the lease liability recorded upon adoption of IFRS 16.

Capital Resources

The Company's objectives when managing capital are to safeguard the ability to continue as a going concern, to provide adequate return to shareholders, to meet external capital requirements, and to preserve financial flexibility in order to benefit from potential opportunities that may arise. Our principal cash requirements are for operations, working capital, and capital expenditures.

The Company's officers are responsible for managing the Company's capital and do so through quarterly meetings and regular review of financial information. The Board of Directors is responsible for overseeing this process. In managing its capital, the Company considers changes in economic conditions, risks that impact operations, and future significant capital investment opportunities. For the three months ended December 31, 2019, there were no changes in our approach to capital management.

The Company's liquid assets were as follows:

	December 31, 2019	September 30, 2019
Cash	$ 546,264	$ 752,911
Cash equivalents	1,372,254	1,999,091
Short-term investments	7,574,513	7,537,262
	$ 9,493,031	$ 10,289,264

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

The Company had commitments of $1,381,609 as at December 31, 2019, primarily for equipment purchases, operating costs in respect of leased office space and contracted equipment maintenance. Management has reviewed its projected funding requirements for the next twelve months and expects that, through the generation and collection of revenues, the Company will maintain sufficient liquidity to meet its requirements.

Non-IFRS Financial Measures

In addition to results reported in accordance with IFRS, the Company discloses Adjusted EBITDA as a supplemental indicator of its financial performance.

The Company defines Adjusted EBITDA as net income (loss) excluding the impact of interest and financing costs (net of interest income), foreign exchange gain (loss), income taxes, depreciation and amortization, share-based compensation, and restructuring costs. The Company believes Adjusted EBITDA is a useful measure as it provides information to management about the operating and financial performance of the Company and its ability to generate operating cash flow to fund future working capital needs, as well as fund future growth. Adjusted EBITDA may also be used by investors and analysts for the purpose of valuing the Company.

Readers are cautioned that these non-IFRS definitions are not recognized measures under IFRS, do not have standardized meanings prescribed by IFRS, and should not be construed to be alternatives to net earnings determined in accordance with IFRS, or as indicators of performance or liquidity or cash flows. The Company's method of calculating these measures may differ from methods used by other entities or in other jurisdictions. The Company uses these measures because it believes they provide useful information to both management and investors with respect to the operating and financial performance of the Company.

	Three months ended December 31	
	2019	2018
Net loss	$ (782,490)	$(1,131,910)
Finance income	(33,445)	(52,373)
Foreign exchange (gain) loss	22,643	(47,144)
Depreciation and amortization	395,968	385,369
Share-based compensation	136,861	147,989
Restructuring costs	-	815,700
Adjusted EBITDA	$ (260,463)	$ 117,631

Financial Instruments

The Company considers the management of financial risk to be an important part of its overall corporate risk management policy. The nature and extent of risks arising from financial instruments and their related risk management are described in note 13 of the consolidated financial statements for the year ended September 30, 2019. In the three months ended December 31, 2019, there was no material change to the nature of the risks arising from our classification of financial instruments, or related risk management objectives.

CAPITAL STRUCTURE AND OUTSTANDING SHARE DATA

The Company maintains an equity incentive plan consisting of a stock option plan and an RSU plan to grant options and RSUs to eligible participants. The obligations under the RSU plan can be settled at the Company's discretion through either cash or issuance of common shares. The Company intends to settle the obligation through the issuance of common shares.

	December 31, 2019		September 30, 2019	
	Number	Weighted average exercise price	Number	Weighted average exercise price
Common shares outstanding	69,200,125		69,200,125	
Options				
Outstanding	5,014,000	$ 0.78	3,535,000	$ 0.95
Exercisable	3,357,875	$ 0.93	2,628,750	$ 1.05
RSUs				
Outstanding	510,481	N/A	225,502	N/A

As at February 12, 2020, the Company has 69,200,125 common shares issued and outstanding. There are no preferred shares issued and outstanding.

SIGNIFICANT ACCOUNTING POLICIES

IFRS 16 – Leases

In January 2016, the IASB issued IFRS 16 – *Leases*, which supersedes IAS 17 – *Leases*. IFRS 16 establishes principles for the recognition, measurement, presentation and disclosure of leases. The standard establishes a single model for lessees to bring leases on balance sheet while lessor accounting remains largely unchanged and retains the finance and operating lease distinctions. IFRS 16 is effective for annual periods beginning on or after January 1, 2019. The Company adopted the standard on October 1, 2019, using the modified retrospective approach. The modified retrospective approach applies the requirements of the standard retrospectively with the cumulative effects of initial application recorded in opening accumulated deficit as at October 1, 2019, and no restatement of the comparative period.

On October 1, 2019, the Company had two real estate leases which were impacted by the adoption of the standard. The Company recognized right-of-use assets of $780,767, net of tenant inducements of $35,001, and lease liabilities of $815,768 related to these leases. The right-of-use assets are depreciated on a straight-line basis over the remaining lease term. The lease liability is carried at amortized cost with a finance charge recorded from the amortization of the lease liability discount. The depreciation expense of the right-of-use assets and the finance charge of the lease liability will partially replace the lease-related expenses recorded in general and administration expense.

On November 6, 2019, the Company signed a lease extension and modification agreement to combine the leases and extend the term to April 30, 2025. As required by the standard, the Company remeasured the lease liability by discounting the revised lease payments using an unchanged incremental borrowing rate of 4.5% and made a corresponding adjustment to the right-of-use asset of $267,778.

Upon adoption of IFRS 16, the Company updated its lease accounting policy as follows:

The Company assesses whether a contract is or contains a lease at the inception of the contract. Leases are recognized as a right-of-use asset and corresponding lease liability at the lease commencement date. The lease liability is measured at the present value of the future fixed payments and variable lease payments that depend on an index or rate over the lease term, less any lease incentives receivable, discounted using the lessee's incremental borrowing rate, unless the implicit interest rate in the lease can be easily determined. Lease liabilities are subsequently measured at amortized cost using the effective interest rate method. Lease terms applied are the contractual non-cancellable periods of the lease, plus periods covered by renewal or termination options, if the Company is reasonably certain to exercise those options. Lease liabilities are remeasured (with a corresponding adjustment to the right-of-use asset) when there is a change in the lease term, a change in the future lease payments resulting from a change in an index or rate used to determine those payments, or when the lease contract is modified and the lease modification is not accounted for as a separate lease.

The right-of-use assets include the initial measurement of the corresponding lease liabilities, lease payments at or before the commencement date, any initial direct costs, less any lease incentives received before the commencement date. The right-of-use assets are subsequently measured at cost and are depreciated on a straight-line basis from the date the underlying asset is available for use over the lease term.

ADDITIONAL INFORMATION

Strategic Update

In 2020, the Company is pursuing revenue growth by focusing on product sales opportunities in both the brand protection market and in the government and banknote market. To achieve these goals, management previously established the following targets for fiscal 2020:

- ***Develop strategic sales relationships.*** *Expand the Company's sales reach by partnering with more established OEMs in both the government and banknote market and in the brand protection market to promote Nanotech's products to their existing customer bases.*

  The Company made significant progress in strengthening our sales partnerships. In the brand protection market, management has partnered with two United States channel partners who have recently begun marketing our LiveOptik products. In the government and banknote market, management has begun discussions with several OEM's to design a marketing housenote to enable the OEM's to begin marketing our KolourOptik products later this year.

- ***Develop strategic manufacturing and product partnerships.*** *Partner with select manufacturers that have a proven track record of excellence to reduce the manufacturing risk associated with scaling product sales and to expand the Company's product lines.*

  The Company has broadened its manufacturing partnerships to include a large OEM partner to produce LiveOptik products for the brand protection market. Nanotech's product offering has expanded to include foils, labels, QR codes, and track and trace capability as a result of its manufacturing partnerships. Outsourcing LiveOptik manufacturing also enables the company to focus on its core capabilities in technology development.

  In the government and banknote market, management is in the process of qualifying a world class OEM manufacturing partner for its KolourDepth products. Management expects to have this finalized within six months, which will enable the Company to deliver on large volume banknote opportunities.

- ***Revenue diversification.*** *Increase product revenue by generating sales of nano-optic products, expanding product lines and by pursuing further growth opportunities for LumaChrome colour-shifting film.*

  In the first quarter of fiscal 2020, Nanotech recorded product revenue from eight delivered customer orders, compared to only two in the first quarter of fiscal 2019. These orders were predominantly for LumaChrome and included film for one new banknote and one new government ID application. In addition, the Company worked with several partners to qualify its LumaChrome product on four new banknote opportunities.

  In the brand protection market, the Company delivered its first LiveOptik sale in the licensing vertical to the World Baseball Softball Confederation and worked with a partner to deliver film for a new commercial application. Although these initial orders are small, they have opportunities to be recurring and to grow in the future.

The Company continues to make further investments in its sales and marketing team and initiatives to expand Nanotech's market reach. During the first quarter of fiscal 2020, these investments included rebranding the Company and its products, launching a new website, and increasing sales activity around several key customers. Management expects to add to the sales and marketing teams in the coming quarters to increase Nanotech's sales reach in the brand protection market and to enhance product management.

While focusing on early reference account sales in the brand protection market, the Company continues to derive most of its revenue from contract services to develop a novel banknote security feature for a G10 central bank. Contract services awarded for fiscal 2020 indicate modest revenue growth compared to fiscal 2019, with some additional opportunities for further awards and revenue growth in fiscal 2020. While the Company does not have visibility on if or when Nanotech's feature might be integrated into the customer's banknotes, management continues to be pleased with the progress of this project.

In the near-term, management expects that Adjusted EBITDA losses will continue as the Company continues to invest in sales and marketing activities to drive future revenue growth. In addition, quarterly results may vary significantly depending on the timing of new product orders and recurring LumaChrome orders which typically affect our third and fourth quarters. With a strong balance sheet, including $9.5 million in cash and short-term investments and no debt, the Company is well positioned to continue to pursue its product-based sales and marketing strategies in 2020.

Public Securities Filings

Additional information about Nanotech can be found at the Company's website www.nanosecurity.ca, the Canadian disclosure filings website www.sedar.com or the OTCMarkets disclosure filings website www.otcmarkets.com.

Condensed Interim Financial Statements of

Nanotech Security Corp.

Three months ended December 31, 2019 and 2018
(Unaudited)

Nanotech Security Corp.

Condensed Interim Statements of Operations and Comprehensive Loss
(Unaudited)

Three months ended December 31, 2019 and 2018
(In Canadian dollars)

		2019		2018
				Restated note 2(a)
Revenue (note 2(a) and note 10)	$	1,469,926	$	1,531,673
Cost of sales (note 11)		305,809		361,548
		1,164,117		1,170,125
Expenses (note 11)				
Research and development		401,932		336,111
General and administration		590,420		537,567
Sales and marketing		586,050		444,714
Depreciation and amortization		370,489		370,759
Restructuring costs (note 12)		-		815,700
		1,948,891		2,504,851
Loss from operations before other (income) expenses		(784,774)		(1,334,726)
Other (income) expenses				
Foreign exchange (gain) loss		22,643		(47,144)
Finance income (note 6)		(33,445)		(52,373)
Tenant income		(44,432)		(59,178)
Steam (income) expense (note 2(a))		52,950		(44,121)
		(2,284)		(202,816)
Net loss and total comprehensive loss	$	(782,490)	$	(1,131,910)
Basic and diluted loss per share:				
Net loss	$	(0.01)	$	(0.02)
Weighted average number of common shares				
Basic and diluted		69,200,125		68,771,501

See accompanying notes to the condensed interim financial statements.

Nanotech Security Corp.
Condensed Interim Statements of Financial Position
(Unaudited)

(In Canadian dollars)

	December 31, 2019	September 30, 2019
Assets		
Current assets:		
Cash and cash equivalents (note 9(c))	$ 1,918,518	$ 2,752,002
Short-term investments (note 4)	7,574,513	7,537,262
Accounts receivable	774,603	503,660
Inventory (note 5)	189,398	237,264
Prepaid expenses and other assets	350,221	419,753
	10,807,253	11,449,941
Property, plant and equipment	15,496,636	15,684,845
Goodwill	1,388,458	1,388,458
Right-of-use asset (note 3)	1,003,526	-
	$ 28,695,873	$ 28,523,244
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 1,030,684	$ 1,232,159
Deposit	530,368	543,368
Current portion of lease liability (note 3)	154,978	-
	1,716,030	1,775,527
Non-current liabilities:		
Tenant inducement	-	16,083
Lease liability (note 3)	893,838	-
	2,609,868	1,791,610
Shareholders’ equity		
Share capital (note 7(a))	62,355,479	62,355,479
Contributed surplus (note 7(b))	3,267,713	3,130,852
Deficit	(39,537,187)	(38,754,697)
	26,086,005	26,731,634
	$ 28,695,873	$ 28,523,244

Related party transactions (note 8)
Commitments (note 14)
See accompanying notes to the condensed interim financial statements.

Approved on behalf of the Board of Directors:

"Neil McDonnell"
Neil McDonnell, Director

"Ronan McGrath"
Ronan McGrath, Director

Nanotech Security Corp.

Condensed Interim Statements of Changes in Shareholders' Equity
(Unaudited)

Three months ended December 31, 2019 and 2018
(In Canadian dollars)

	Number of shares	Share capital	Contributed surplus	Deficit	Total shareholders' equity
Balance as at October 1, 2018	68,771,501	$ 61,892,395	$ 2,930,964	$ (35,919,443)	$ 28,903,916
Net loss	-	-	-	(1,131,910)	(1,131,910)
Share-based compensation - options (note 7(b)(i))	-	-	95,884	-	95,884
Share-based compensation - RSUs (note 7(b)(ii) and note 12)	-	-	52,105	-	52,105
Balance as at December 31, 2018	68,771,501	$ 61,892,395	$ 3,078,953	$ (37,051,353)	$ 27,919,995
Balance as at October 1, 2019	69,200,125	$ 62,355,479	$ 3,130,852	$ (38,754,697)	$ 26,731,634
Net loss	-	-	-	(782,490)	(782,490)
Share-based compensation - options (note 7(b)(i))	-	-	115,898	-	115,898
Share-based compensation - RSUs (note 7(b)(ii))	-	-	20,963	-	20,963
Balance as at December 31, 2019	69,200,125	$ 62,355,479	$ 3,267,713	$ (39,537,187)	$ 26,086,005

See accompanying notes to the condensed interim financial statements.

Nanotech Security Corp.

Condensed Interim Statements of Cash Flows
(Unaudited)

Three months ended December 31, 2019 and 2018
(In Canadian dollars)

	2019	2018
Cash flows provided by (used in):		
Operating activities:		
Net loss from continuing operations	$ (782,490)	$ (1,131,910)
Items not involving cash:		
Depreciation and amortization (note 11)	395,968	385,369
Share-based compensation (note 11 and note 12)	136,861	147,989
Unrealized foreign exchange gain	(24,478)	(33,061)
Finance income (note 6)	(33,445)	(52,373)
Other	(581)	(5,714)
Non-cash working capital changes (note 9(a))	(318,823)	1,939,532
Interest paid on lease liability	(11,051)	-
Interest received	78,476	43,815
	(559,563)	1,293,647
Net cash used in discontinued operations (note 13)	-	(52)
Cash provided by (used in) operating activities	(559,563)	1,293,595
Investing activities:		
Purchase of property and equipment (note 9(d))	(188,055)	(25,540)
Net acquisition of short-term investments	(70,650)	(24,936)
Cash used in investing activities	(258,705)	(50,476)
Financing activities:		
Repayment of lease liability	(34,730)	-
Cash used in financing activities	(34,730)	-
Effect of foreign exchange on cash and cash equivalents	19,514	27,591
Increase (decrease) in cash and cash equivalents	(833,484)	1,270,710
Cash and cash equivalents, beginning of period	2,752,002	2,014,764
Cash and cash equivalents, end of period	$ 1,918,518	$ 3,285,474

See supplementary cash flow information (note 9)
See accompanying notes to the condensed interim financial statements.

1. Summary of business

Nanotech Security Corp. (the "Company" or "Nanotech") is incorporated under the laws of British Columbia with common shares listed on the TSX Venture Exchange (trading symbol: NTS) and quoted in the United States on the OTCQX Market (trading symbol: NTSFF). The Company's head office is located at #505 - 3292 Production Way, Burnaby, British Columbia, Canada V5A 4R4.

Nanotech researches, creates, and produces nano-optic structures and colour-shifting materials used in authentication and brand protection applications across a wide range of markets including banknotes, secure government documents, and commercial branding.

2. Basis of preparation

(a) *Statement of compliance*

These condensed interim financial statements are prepared in accordance with International Accounting Standards ("IAS") 34 – *Interim Financial Reporting*, as issued by the International Accounting Standards Board ("IASB") on a basis consistent with those followed in the most recent annual consolidated financial statements, with the exception of a new accounting policy that was adopted on October 1, 2019 as described in note 3.

These condensed interim financial statements do not include all of the information required for full annual financial statements and should be read in conjunction with the Company's audited consolidated financial statements for the year ended September 30, 2019.

Certain comparative figures in the condensed interim statements of operations and comprehensive loss have been reclassified to conform to the current period's presentation. This reclassification had no impact on the net loss and total comprehensive loss.

For the three months ended December 31, 2018, revenue and cost of sales were adjusted to reflect the reclassification of steam from revenue to other income under IFRS 15 – *Revenue from Contracts with Customers*. Revenue was previously reported as $1,723,877 and restated as $1,531,673, due to a reclass of $192,204 to other income. Cost of sales for the three months ended December 31, 2018 was previously reported as $509,631 and restated as $361,548, due to a reclass of $148,083 to other income. There was no impact on net loss and total comprehensive loss.

These condensed interim financial statements were approved and authorized for issue by the Company's Board of Directors on February 12, 2020.

(b) *Basis of measurement*

These condensed interim financial statements are presented in Canadian dollars and have been prepared on a historical cost basis.

3. Change in accounting policy

IFRS 16 – Leases

In January 2016, the IASB issued IFRS 16 – *Leases*, which supersedes IAS 17 – *Leases*. IFRS 16 establishes principles for the recognition, measurement, presentation and disclosure of leases. The standard establishes a single model for lessees to bring leases on balance sheet while lessor accounting remains largely unchanged and retains the finance and operating lease distinctions. IFRS 16 is effective for annual periods beginning on or after January 1, 2019. The Company adopted the standard on October 1, 2019, using the modified retrospective approach. The modified retrospective approach applies the requirements of the standard retrospectively with the cumulative effects of initial application recorded in opening accumulated deficit as at October 1, 2019, and no restatement of the comparative period.

(In Canadian dollars)

3. Change in accounting policy (continued)

IFRS 16 – Leases (continued)

On October 1, 2019, the Company had two real estate leases for office space which were impacted by the adoption of the standard. The Company recognized right-of-use assets of $780,767, net of tenant inducements of $35,001, and lease liabilities of $815,768 related to these leases. The right-of-use assets are depreciated on a straight-line basis over the remaining lease term. The lease liability is carried at amortized cost with a finance charge recorded from the amortization of the lease liability discount. The depreciation expense of the right-of-use assets and the finance charge of the lease liability will partially replace the lease-related expenses recorded in general and administration expense.

The following table reconciles the operating lease commitments included in the September 30, 2019 commitments note to the lease liability recorded on transition as at October 1, 2019:

Operating lease commitments as at September 30, 2019	$	281,029
Discounted using the incremental borrowing rate as at October 1, 2019		(17,990)
Lease liabilities recognized as at October 1, 2019		263,039
Extension options reasonably certain to be exercised		552,729
Lease liabilities recognized as at October 1, 2019	$	815,768

On November 6, 2019, the Company signed a lease extension and modification agreement to combine the leases and extend the term to April 30, 2025. As required by the standard, the Company remeasured the lease liability by discounting the revised lease payments using an unchanged incremental borrowing rate of 4.5% and made a corresponding adjustment to the right-of-use asset of $267,778.

The following table reconciles the change in the right-of-use asset for the period ended December 31, 2019:

Balance on transition, October 1, 2019	$	780,767
Lease modification		267,778
Depreciation		(45,019)
Balance as at December 31, 2019	$	1,003,526

The following table reconciles the change in the lease liability and discloses a maturity analysis of the lease liability for the period ended December 31, 2019:

Balance on transition, October 1, 2019	$	815,768
Lease modification		267,778
Accretion of lease liability (note 6)		11,051
Repayment of principal and interest		(45,781)
Balance as at December 31, 2019	$	1,048,816
Minimum lease payments:		
Less than one year	$	199,177
Between one and five years		907,039
More than five years		81,220
		1,187,436
Less future finance charges		(138,620)
	$	1,048,816
Current portion	$	154,978
Non-current portion		893,838
Balance as at December 31, 2019	$	1,048,816

(In Canadian dollars)

3. Change in accounting policy (continued)

IFRS 16 – Leases (continued)

Upon adoption of IFRS 16, the Company updated its lease accounting policy as follows:

The Company assesses whether a contract is or contains a lease at the inception of the contract. Leases are recognized as a right-of-use asset and corresponding lease liability at the lease commencement date. The lease liability is measured at the present value of the future fixed payments and variable lease payments that depend on an index or rate over the lease term, less any lease incentives receivable, discounted using the lessee's incremental borrowing rate, unless the implicit interest rate in the lease can be easily determined. Lease liabilities are subsequently measured at amortized cost using the effective interest rate method. Lease terms applied are the contractual non-cancellable periods of the lease, plus periods covered by renewal or termination options, if the Company is reasonably certain to exercise those options. Lease liabilities are remeasured (with a corresponding adjustment to the right-of-use asset) when there is a change in the lease term, a change in the future lease payments resulting from a change in an index or rate used to determine those payments, or when the lease contract is modified and the lease modification is not accounted for as a separate lease.

The right-of-use assets include the initial measurement of the corresponding lease liabilities, lease payments at or before the commencement date, any initial direct costs, less any lease incentives received before the commencement date. The right-of-use assets are subsequently measured at cost and are depreciated on a straight-line basis from the date the underlying asset is available for use over the lease term.

4. Short-term investments

Short-term investments of $7,574,513 (September 30, 2019 - $7,537,262) consist of cashable term deposits held with a Canadian chartered bank. The term deposits have maturity dates between April 17, 2020 and December 22, 2020. Interest rates range between 2.01% and 2.02%.

5. Inventory

	December 31, 2019	September 30, 2019
Raw materials	$ 125,160	$ 134,435
Work in progress	58,030	100,087
Finished goods	6,208	2,742
	$ 189,398	$ 237,264

There were inventory write-downs of $nil during the three months ended December 31, 2019 (December 31, 2018 - $47,513). For the three months ended December 31, 2019, the Company recognized inventories of $143,115 (December 31, 2018 - $45,693) as expensed through cost of sales.

6. Finance income

	Three months ended December 31	
	2019	2018
Interest income from cash and cash equivalents and short-term investments	$ (46,986)	$ (54,446)
Interest paid on lease liability	11,051	-
Other interest expenses	2,490	2,073
	$ (33,445)	$ (52,373)

(In Canadian dollars)

7. Share capital

(a) *Share capital*

Authorized:

Unlimited number of common shares with no par value

Unlimited number of preferred shares with no par value

Common shares issued and fully paid:

	Number of shares	Amount
Balance as at September 30, 2019 and December 31, 2019	69,200,125	$ 62,355,479

There are no preferred shares issued and outstanding.

(b) *Share-based payment plans*

(i) Stock option plan

Under the Company’s share incentive plan, the maximum number of shares that may be reserved for grant of options at any point in time is 10% of the outstanding shares, less any shares reserved for issuance under the restricted share unit (“RSU”) plan. The following stock options were outstanding as at December 31, 2019:

	Number of options	Weighted average exercise price
Balance as at September 30, 2019	3,535,000	$ 0.95
Granted	1,479,000	0.40
Balance as at December 31, 2019	5,014,000	$ 0.78

The following table summarizes information pertaining to the Company’s stock options outstanding as at December 31, 2019:

	Options outstanding			Options exercisable	
Range of exercise prices	Number of options outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
$0.00 - $0.50	1,479,000	4.96	$ 0.40	369,750	$ 0.40
$0.51 - $0.75	1,677,500	3.74	0.61	1,155,625	0.61
$1.01 - $1.25	1,126,500	1.19	1.14	1,101,500	1.13
$1.26 - $1.50	731,000	2.26	1.42	731,000	1.42
	5,014,000	3.31	$ 0.78	3,357,875	$ 0.93

(In Canadian dollars)

7. Share capital (continued)

(b) *Share-based payment plans (continued)*

(i) Stock option plan (continued)

The Company calculates the fair value of the options at the grant date using the Black-Scholes option-pricing model. The table below outlines the weighted average assumptions used to estimate the fair value of options granted during the three month periods ended December 31, 2019 and 2018:

	Three months ended December 31	
	2019	2018
Risk free interest rate	1.5%	2.3%
Expected life	5.0	5.0
Expected volatility	51.4%	44.4%
Expected dividends	Nil	Nil
Average fair value	$0.18	$0.22

The Company charged the following share-based payments to operating expenses in connection with the Company's stock option plan, with a corresponding increase in contributed surplus:

	Three months ended December 31	
	2019	2018
Total compensation – stock options	$ 115,898	$ 95,884

(ii) Restricted share unit plan

RSUs outstanding as at December 31, 2019:

	Number of RSUs
Balance as at September 30, 2019	225,502
Granted	284,979
Balance as at December 31, 2019	510,481

For the three months ended December 31, 2019, the Company charged the following share-based payments to operating expenses in connection with the Company's RSU plan, with a corresponding increase in contributed surplus:

	Three months ended December 31	
	2019	2018
Total compensation - RSUs	$ 20,963	$ 52,105

8. Related party transactions

(a) *Remuneration of key management personnel*

	Three months ended December 31	
	2019	2018
Salaries, accrued bonuses, employee benefits and director fees	$ 193,944	$ 166,582
Share-based payments	79,241	102,852
Restructuring costs (note 12)	-	815,700
	$ 273,185	$ 1,085,134

(In Canadian dollars)

8. Related party transactions (continued)

(b) As at December 31, 2019, amounts owing to a company controlled by a director of the Company included in accounts payable and accrued liabilities were $84,457 (September 30, 2019 - $90,938). These payables represent amounts owing upon the termination of an executive services consulting agreement (note 12).

(c) Legal and professional fees, taxes and disbursements totaling $nil for the three months ended December 31, 2019 (December 31, 2018 - $14,506) were incurred with a law firm of which a director of the Company is a partner.

The above transactions are in the normal course of business and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

9. Supplementary cash flow information

(a) Change in non-cash working capital

	Three months ended December 31	
	2019	2018
Accounts receivable	$ (267,947)	$ 1,121,538
Inventory	46,557	8,249
Prepaid expenses and other assets	71,894	31,016
Accounts payable and accrued liabilities (note 9(d))	(156,327)	778,729
Deposit	(13,000)	-
	$ (318,823)	$ 1,939,532

(b) Income taxes

The Company did not pay any income taxes during the three months ended December 31, 2019 and 2018.

(c) Cash and cash equivalents

Cash and cash equivalents consist of cash balances with banks, investments with original maturities of three months or less, and investments that are both readily convertible to cash and subject to insignificant changes in market value:

	December 31, 2019	September 30, 2019
Cash	$ 546,264	$ 752,911
Cash equivalents	1,372,254	1,999,091
	$ 1,918,518	$ 2,752,002

(d) Supplemental disclosure of non-cash investing activities

As at December 31, 2019, property, plant and equipment included in accounts payable was $35,225 (December 31, 2018 - $32,555).

(In Canadian dollars)

10. Revenue and segmented information

The Company's operations currently consist of one operating segment. Within this operating segment, revenue is disaggregated by type as follows:

	Three months ended December 31	
	2019	2018 Restated note 2(a)
Contract services	$ 1,226,537	$ 1,478,210
Products and services	243,389	53,463
	$ 1,469,926	$ 1,531,673

For the three months ended December 31, 2019, sales within Canada were $73,254 (December 31, 2018 - $nil) and sales outside Canada were $1,396,672 (December 31, 2018 - $1,531,673).

During the three months ended December 31, 2019, the Company had one customer who represented greater than 10% of total revenues. This customer represented approximately 83% of total revenues (December 31, 2018 – one customer represented approximately 97% of total revenues).

11. Nature of expenses

The expenses presented below represent total cost of sales, research and development, general and administration expenses, sales and marketing, depreciation and amortization and restructuring costs.

	Three months ended December 31	
	2019	2018 Restated note 2(a)
Salaries and benefits	$ 931,406	$ 729,284
Share-based compensation	136,861	147,989
Depreciation and amortization	395,968	385,369
Travel and entertainment	98,504	73,602
Professional fees and insurance	242,262	182,818
Public company costs	91,990	111,870
Rent and utilities	152,687	172,913
Maintenance and office expenses	118,071	81,562
Materials consumed	86,951	165,292
Restructuring costs (note 12)	-	815,700
	$ 2,254,700	$ 2,866,399

12. Restructuring costs

On December 21, 2018, the Board implemented an executive transition plan, under which Mr. Doug Blakeway, the former CEO, transitioned his responsibilities to Mr. Troy Bullock. Under the terms of this transition plan, Mr. Blakeway's executive services consulting agreement was terminated, triggering the following termination benefits as laid out in the agreement: two years base salary, a pro-rated performance bonus, and vesting of all outstanding share-based awards. The Company incurred restructuring costs of $815,700 for the three month period ended December 31, 2018, of which $92,200 represented share-based compensation related to the accelerated vesting of Mr. Blakeway's RSUs.

In January 2019, termination benefits were paid and 187,500 shares were issued to Mr. Blakeway upon vesting of his RSUs. Restructuring costs of $84,375 remain accrued as at December 31, 2019 (September 30, 2019 - $84,375).

(In Canadian dollars)

13. Discontinued operations

On September 21, 2017, the directors of the Company made the determination to pursue the possible sale of the assets of its subsidiary, Tactical Technologies Inc. (“Tactical”), to a third party. At September 30, 2017, Tactical was classified as a separate disposal group held for sale and as a discontinued operation.

On June 29, 2018, the assets used in connection with Tactical’s surveillance equipment and van conversion business were sold to an employee of Tactical for a nominal amount and on September 28, 2018, Tactical was wound-up and struck from the corporate register.

The cash flows for the period ended December 31, 2018 includes the effects of extinguishment of remaining liabilities pursuant to the disposal.

14. Commitments

As at December 31, 2019, the Company is committed to equipment purchases, operating costs in respect of leased office space, and to contracted equipment maintenance for the following amounts:

2020	$	502,485
2021		263,712
2022		257,208
2023		188,458
2024		107,208
2025		62,538
	$	1,381,609