



December 31, 2020

QUARTERLY REPORT



Nanotech Security Corp.

Management's Discussion and Analysis
For the three months ended December 31, 2020

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 quarter ended December 31, 2020.

ADVISORY

This MD&A, dated February 10, 2021, 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, 2020 as well as with the Company's audited financial statements and MD&A for the year ended September 30, 2020. 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, the Company's views that its optics-based technologies will continue to show promise for large scale production, and the potential impacts of the COVID-19 pandemic on the Company's operations. 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, as well as risks related to the COVID-19 pandemic.

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 financial statements for the year ended September 30, 2020, 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.

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GENERAL OVERVIEW

Nanotech is incorporated under the laws of British Columbia, 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 develops and produces nano-optic structures and colour-shifting foils 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®**, a patented visual 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 optical 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™**, a patented visual technology that utilizes innovative nano-optics one tenth the size of traditional holographic structures to create next generation overt security features customized to Nanotech's 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 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, 2020 and 2019:

Select Financial Information		
	2020	2019
Revenue	\$ 1,712,250	\$ 1,469,926
Cost of sales	323,173	305,809
	1,389,077	1,164,117
Expenses		
Research and development	640,979	401,932
General and administration	566,423	590,420
Sales and marketing	456,971	586,050
Depreciation and amortization	373,663	370,489
	2,038,036	1,948,891
Loss from operations before other (income) expenses	(648,959)	(784,774)
Other (income) expenses	56,140	(2,284)
Net loss	\$ (705,099)	\$ (782,490)
Adjusted EBITDA ⁽¹⁾	\$ (196,574)	\$ (251,945)

⁽¹⁾Adjusted EBITDA is a non-IFRS measure as described in the Non-IFRS Financial Measures section of this MD&A. The calculation of Adjusted EBITDA for the three months ended December 31, 2019 was amended to exclude tenant and steam (income) expenses, which are no longer expected to be recurring in nature. See the Quarterly Results section of this MD&A for the revised historical figures on a quarterly basis.

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Revenue

The Company currently derives a 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 increased \$449,163 or 37% in the three months ended December 31, 2020 compared to the same period last year.

Total revenue for the three months ended December 31, 2020 increased by \$242,324 or 16% to \$1,712,250, compared to \$1,469,926 in the same period last year, due to higher contract services revenue partially offset by a decrease in product revenue in the current period.

Gross Margin

Gross margin for the three months ended December 31, 2020 increased by \$224,960 or 19% to \$1,389,077, compared to \$1,164,117 in the same period last year as a result of the increase in total revenue. The gross margin percentage was 81% for the three months ended December 31, 2020, up from 79% in the same period last year. This increase was primarily due to the increase in higher margin contract services revenue in the current period.

Research and Development

Research and development expenditures for the three months ended December 31, 2020 were \$640,979, compared to \$401,932 in the same period last year. This increase is in line with management's plan to make strategic investments in research and development to bring new products to market in fiscal 2021. The Company hired additional research and development staff and increased patent expenditures in the current period.

General and Administration

General and administration expenditures for the three months ended December 31, 2020 were \$566,423, a decrease of \$23,997 or 4%, compared to \$590,420 in the same period last year. The decrease was primarily due to decreased share-based compensation and professional fees in the current period, partially offset by higher utilities expense.

Sales and Marketing

Sales and marketing expenditures for the three months ended December 31, 2020 were \$456,971, a decrease of \$129,079 or 22%, compared to \$586,050 in the same period last year. This decrease was primarily due to decreased share-based compensation, travel and conference expenses, and consulting fees in the current period.

Depreciation and Amortization

Depreciation and amortization expense included in operating expenditures for the three months ended December 31, 2020 were \$373,663, consistent with \$370,489 in the same period last year.

Other (Income) Expense

Other expense for the three months ended December 31, 2020 was \$56,140, an increase of \$58,424 compared to other income of \$2,284 in the same period last year. Finance income decreased in the current period due to lower interest rates while foreign exchange loss increased compared to the same period last year. In addition, there was no tenant and steam income or expense in the current period as a result of the termination of tenant and steam agreements during the second quarter of 2020.

Adjusted EBITDA

Adjusted EBITDA for the three months ended December 31, 2020 was negative \$196,574, compared to negative \$251,945 during the same period last year. The decrease was primarily due to increased revenue and higher profit margins in the current period in combination with decreased sales and marketing expenses in the COVID-19 environment, partially offset by increased research and development expenses as the Company continued to invest in its research and development team.

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Net Loss

Net loss for the three months ended December 31, 2020 was \$705,099, compared to net loss of \$782,490 during the same period last year. The decrease in net loss was primarily due to increased revenue and higher profit margins in combination with reduced sales and marketing expenses in the current period, partially offset by increased research and development expenditures and a reduction in other income.

QUARTERLY RESULTS

	Q1 2021	Q4 2020	Q3 2020	Q2 2020	Q1 2020	Q4 2019	Q3 2019	Q2 2019
(\$ thousands, except per share data)								
Revenue	\$1,712	\$2,913	\$1,947	\$1,385	\$1,470	\$1,450	\$1,827	\$1,594
Net income (loss)	(705)	293	(332)	(973)	(782)	(705)	(521)	(477)
Adjusted EBITDA ⁽¹⁾	(197)	953	198	(567)	(252)	(263)	(77)	(74)
Basic earnings (loss) per share:								
Net income (loss)	(0.01)	0.00	(0.00)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
Diluted earnings (loss) per share:								
Net income (loss)	(0.01)	0.00	(0.00)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)

⁽¹⁾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. There are no seasonal effects in the Company's business over the quarters presented.

RELATED PARTY TRANSACTIONS

For the three months ended December 31, 2020 and 2019, 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	
	2020	2019
Salaries, accrued bonuses, employee benefits and director fees	\$ 202,262	\$ 193,944
Share-based payments	29,237	79,241
	\$ 231,499	\$ 273,185

(b) As at December 31, 2020, amounts owing to directors for director fees and expense reimbursements included in accounts payable and accrued liabilities were \$13,100 (September 30, 2020 - \$58,619).

(c) On January 15, 2021, the Company purchased six patents from a company owned by a director of the Company for \$100,000 and agreed to share 10% of any revenues from a specific customer developed in the next two years with ongoing royalties of 3% to 6% on other revenues derived from the patents for a period of five years.

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.

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Summary of Statements of Cash Flows

	Three months ended December 31	
	2020	2019
Cash provided by (used in) operating operations	\$ 69,633	\$ (559,563)
Cash used in investing activities	(278,818)	(258,705)
Cash used in financing activities	(43,467)	(34,730)
Effect of foreign exchange on cash and cash equivalents	26,729	19,514
Cash and cash equivalents, beginning of period	1,751,855	2,752,002
Cash and cash equivalents, end of period	\$ 1,525,932	\$ 1,918,518

Operating Activities

Cash provided by operating activities was \$69,633 for the three months ended December 31, 2020, compared to cash used in operating activities of \$559,563 for the same period last year. The increase in cash provided in operating activities reflects changes in non-cash working capital, particularly related to the collection of accounts receivable in the quarter, in combination with the underlying improvement in revenue and margins that boosted operating results in the current period.

Investing Activities

Cash used in investing activities for the three months ended December 31, 2020 was \$278,818, comparable to \$258,705 during the same period last year.

Financing Activities

Cash used in financing activities for the three months ended December 31, 2020 was \$43,467 compared to \$34,730 in the same period last year, which represents payment of the lease liability.

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. Nanotech's 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, 2020, there were no changes in the Company's approach to capital management. Management will continue to safeguard liquid assets in the short-term to weather the COVID-19 pandemic, while also making capital and other investments required for the long-term operation of the business. The Company is well-positioned with liquid assets of \$8.4 million at quarter end and no debt.

	December 31, 2020	September 30, 2020
Cash	\$ 800,188	\$ 1,026,845
Cash equivalents	725,744	725,010
Short-term investments	6,864,359	6,849,285
	\$ 8,390,291	\$ 8,601,140

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

The Company had commitments of \$844,148 as at December 31, 2020, primarily for operating costs in respect of leased office space, contracted equipment maintenance, and equipment purchases. Management has reviewed its projected funding requirements for the next 12 months and expects that, through the generation and collection of revenues, the Company will maintain sufficient liquidity to meet its requirements.

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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, tenant income, and steam (income) expense. 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, liquidity or cash flows. The Company's method of calculating these measures may differ from methods used by other entities and accordingly Nanotech's measures may not be comparable to similarly titled measures 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	
	2020	2019 ⁽¹⁾
Net loss	\$ (705,099)	\$ (782,490)
Finance income	(2,982)	(33,445)
Foreign exchange loss	59,122	22,643
Depreciation and amortization	379,853	395,968
Share-based compensation	72,532	136,861
Tenant income	-	(44,432)
Steam expense	-	52,950
Adjusted EBITDA	\$ (196,574)	\$ (251,945)

⁽¹⁾ The calculation of Adjusted EBITDA was amended to exclude tenant and steam (income) expenses, which are no longer expected to be recurring in nature. See the Quarterly Results section of this MD&A for the revised historical figures on a quarterly basis.

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 audited financial statements for the year ended September 30, 2020. In the three months ended December 31, 2020, there was no material change to the nature of the risks arising from Nanotech's classification of financial instruments or related risk management objectives. Management is monitoring the impact of COVID-19 on credit risk and will mitigate any increased customer-specific risk with either credit insurance or prepayment, where appropriate.

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CAPITAL STRUCTURE AND OUTSTANDING SHARE DATA

The Company maintains an equity incentive plan consisting of a stock option plan and a restricted share unit ("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, 2020		September 30, 2020	
	Number	Weighted average exercise price	Number	Weighted average exercise price
Common shares outstanding	69,399,861		69,399,861	
Options				
Outstanding	5,500,700	\$ 0.66	4,783,200	\$ 0.68
Exercisable	3,889,700	\$ 0.76	3,383,700	\$ 0.81
RSUs				
Outstanding	549,671	N/A	284,083	N/A

As at February 10, 2021, the Company has 69,399,861 common shares issued and outstanding. There are no preferred shares issued and outstanding.

NEW STANDARDS AND INTERPRETATIONS NOT YET ADOPTED

Classification of Liabilities as Current or Non-Current (Amendments to IAS 1)

In January 2020, IASB issued *Classification of Liabilities as Current or Non-Current*, which amends IAS 1 – *Presentation of Financial Statements*. The narrow scope amendments affect only the presentation of liabilities in the statement of financial position and not the amount or timing of its recognition. It clarifies that the classification of liabilities as current or non-current is based on rights that are in existence at the end of a reporting period and specifies that classification is unaffected by expectations about whether an entity will exercise its right to defer settlement of a liability. It also introduces a definition of 'settlement' to make clear that settlement refers to the transfer to the counterparty of cash, equity instruments, other assets or services. The amendments are effective for annual reporting periods beginning on or after January 1, 2022. Earlier application is permitted. The Company is assessing the potential impact of these amendments.

COVID-19 PANDEMIC

In March 2020, the World Health Organization declared the COVID-19 outbreak a pandemic. The ultimate duration of COVID-19, the magnitude of the impact on the economy, and the full extent to which COVID-19 may have direct and indirect impacts on Nanotech's business is not known at this time. This could include an impact on the Company's ability to obtain debt and equity financing, impairment in the value of long-lived assets, or potential future decrease in revenue or the profitability of Nanotech's operations. The Company has not yet experienced any material negative impacts to its business, results of operations, or its financial position as a result of COVID-19.

As of the date of this MD&A, Nanotech's Thurso, Quebec production facility has been designated an essential service by the Quebec Government and it continues at full operation. Burnaby, BC offices and laboratories also remain open and fully operational. The Company has enforced stringent guidelines to ensure employees in its offices, labs and production facilities are taking appropriate steps to maintain a safe working environment, including working from home where possible.

Nanotech Security Corp.

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For the three months ended December 31, 2020

ADDITIONAL INFORMATION

Strategic Update

The Company remains focused on commercializing its technology for long-term revenue growth, with efforts centered around the following pillars:

1. **Contract services** – The Company's development contract with a confidential G10 central bank remains a strategic focus and significant resources are committed to this project. Developing a visual security feature that could be selected for integration into this customer's banknote would be a significant milestone in the Company's growth.

The Company is restricted from providing substantive information about this project, but management is pleased with the progress of this development contract by securing purchase orders of \$6.7 million for 2021 and potential additional awards of \$1.5 million in fiscal 2021.

2. **Product development** – Based on the positive market feedback of Nanotech's latest nano-optic product offerings, management believes there are extensive opportunities to offer these new visual products with exceptional differentiation in both banknote and brand protection markets. As a result, the Company plans to increase its investment in additional development staff, product trials, and certifications, to drive technology advancement and enhanced product development to generate future revenue.

In the first quarter of 2021 research and development expenditures were \$239,047 higher than the prior year which represents six additional R&D staff brought on to deliver Nanotech's strategic product roadmap. Management plans to have several new product launches in fiscal 2021.

3. **Strategic partnerships** – Nanotech has developed strategic relationships with established OEM manufacturers to enable scalable delivery for our customers. These relationships reduce the Company's manufacturing risk and extend the market reach of Nanotech's product offering. Management is also developing the Company's internal production capability to complement these OEM offerings, which is being optimized for the Company's proprietary KolourOptik technology platform.
4. **Expanded channels to market** – Nanotech will market its products and pursue revenue through both direct sales and strategic channel partners who promote and offer Nanotech's products to their existing customers. Management expects to expand the Company's network of channel partners as new products are launched throughout fiscal 2021.

Product revenue decreased to \$36,550 for the three months ended December 31, 2020, compared to \$243,389 during the same period last year. Nanotech delivered two customer product orders in the quarter, compared to eight in the same period last year. This variance was partially due to the timing of certain recurring orders, which can vary from year to year.

2021 Outlook

The Company has a solid base of 2021 revenue, with secure purchase orders for \$6.7 million dollars relating to contract services and anticipated recurring revenue. Management has reconfirmed its guidance for the year, with revenue growth for 2021 targeted at 15% to 25%, depending on the level of new and recurring LumaChrome sales, additional contract services and successful product launches. Given Nanotech's continued investment in technology, management expects modest Adjusted EBITDA losses in 2021.

With a strong balance sheet including no debt, an expanding IP portfolio, record contract services awards for 2021, and recurring LumaChrome business, the Company is well positioned for future product revenue growth and diversification.

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.otcm Markets.com.

Condensed Interim Financial Statements of

Nanotech Security Corp.

Three months ended December 31, 2020 and 2019
(Unaudited)

Nanotech Security Corp.

Condensed Interim Statements of Operations and Comprehensive Loss
(Unaudited)

Three months ended December 31, 2020 and 2019

(In Canadian dollars)

	2020	2019
Revenue (note 10)	\$ 1,712,250	\$ 1,469,926
Cost of sales (note 11)	323,173	305,809
	<u>1,389,077</u>	<u>1,164,117</u>
Expenses (note 11)		
Research and development	640,979	401,932
General and administration	566,423	590,420
Sales and marketing	456,971	586,050
Depreciation and amortization	373,663	370,489
	<u>2,038,036</u>	<u>1,948,891</u>
Loss from operations before other (income) expenses	(648,959)	(784,774)
Other (income) expenses		
Foreign exchange loss	59,122	22,643
Finance income (note 12)	(2,982)	(33,445)
Tenant income	-	(44,432)
Steam expense	-	52,950
	<u>56,140</u>	<u>(2,284)</u>
Net loss and total comprehensive loss	\$ (705,099)	\$ (782,490)
Basic and diluted loss per share:		
Net loss	\$ (0.01)	\$ (0.01)
Weighted average number of common shares		
Basic and diluted	69,399,861	69,200,125

See accompanying notes to the condensed interim financial statements.

Nanotech Security Corp.

Condensed Interim Statements of Financial Position
(Unaudited)

(In Canadian dollars)

	December 31, 2020	September 30, 2020
Assets		
Current assets:		
Cash and cash equivalents (note 9(c))	\$ 1,525,932	\$ 1,751,855
Short-term investments (note 4)	6,864,359	6,849,285
Accounts receivable	810,335	1,505,391
Inventory (note 5)	218,419	210,715
Prepaid expenses and other assets	284,572	324,974
Asset held for sale (note 6)	125,000	-
	<u>9,828,617</u>	<u>10,642,220</u>
Property, plant and equipment	14,652,664	15,089,496
Goodwill	1,388,458	1,388,458
Right-of-use asset	815,365	862,405
	<u>\$ 26,685,104</u>	<u>\$ 27,982,579</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,030,355	\$ 1,630,754
Deposits	35,027	56,069
Current portion of lease liability	176,902	173,558
	<u>1,242,284</u>	<u>1,860,381</u>
Non-current liabilities:		
Lease liability	716,936	763,747
	<u>1,959,220</u>	<u>2,624,128</u>
Shareholders' equity:		
Share capital (note 7(a))	62,499,841	62,499,841
Contributed surplus (note 7(b))	3,481,185	3,408,653
Deficit	(41,255,142)	(40,550,043)
	<u>24,725,884</u>	<u>25,358,451</u>
	<u>\$ 26,685,104</u>	<u>\$ 27,982,579</u>

Related party transactions (note 8)

Subsequent event (note 8(c))

Commitments and contingencies (note 13)

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, 2020 and 2019
(In Canadian dollars)

	Number of shares	Share capital	Contributed surplus	Deficit	Total shareholders' equity
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
Balance as at October 1, 2020	69,399,861	\$ 62,499,841	\$ 3,408,653	\$ (40,550,043)	\$ 25,358,451
Net loss	-	-	-	(705,099)	(705,099)
Share-based compensation - options (note 7(b)(i))	-	-	56,060	-	56,060
Share-based compensation - RSUs (note 7(b)(ii))	-	-	16,472	-	16,472
Balance as at December 31, 2020	69,399,861	\$ 62,499,841	\$ 3,481,185	\$ (41,255,142)	\$ 24,725,884

See accompanying notes to the condensed interim financial statements.

Nanotech Security Corp.

Condensed Interim Statements of Cash Flows
(Unaudited)

Three months ended December 31, 2020 and 2019
(In Canadian dollars)

	2020	2019
Cash flows provided by (used in):		
Operating activities:		
Net loss	\$ (705,099)	\$ (782,490)
Items not involving cash:		
Depreciation and amortization (note 11)	379,853	395,968
Share-based compensation (note 11)	72,532	136,861
Unrealized foreign exchange gain	(33,482)	(24,478)
Finance income (note 12)	(2,982)	(33,445)
Other	(2,489)	(581)
Non-cash working capital changes (note 9(a))	333,183	(318,823)
Interest paid on lease liability	(10,382)	(11,051)
Interest received	38,499	78,476
Cash provided by (used in) operating activities	69,633	(559,563)
Investing activities:		
Purchase of property and equipment (note 9(d))	(241,097)	(188,055)
Net acquisition of short-term investments	(37,721)	(70,650)
Cash used in investing activities	(278,818)	(258,705)
Financing activities:		
Repayment of lease liability	(43,467)	(34,730)
Cash used in financing activities	(43,467)	(34,730)
Effect of foreign exchange on cash and cash equivalents	26,729	19,514
Decrease in cash and cash equivalents	(225,923)	(833,484)
Cash and cash equivalents, beginning of period	1,751,855	2,752,002
Cash and cash equivalents, end of period	\$ 1,525,932	\$ 1,918,518

See supplementary cash flow information (note 9)

See accompanying notes to the condensed interim financial statements.

Nanotech Security Corp.

Notes to the Condensed Interim Financial Statements
(Unaudited)

Three months ended December 31, 2020 and 2019
(In Canadian dollars)

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 develops and produces nano-optic structures and colour-shifting foils 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 audited financial statements.

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 financial statements for the year ended September 30, 2020.

These condensed interim financial statements were approved and authorized for issue by the Company’s Board of Directors on February 10, 2021.

(b) *Basis of measurement*

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

3. New standards and interpretations not yet adopted

Classification of Liabilities as Current or Non-Current (Amendments to IAS 1)

In January 2020, IASB issued *Classification of Liabilities as Current or Non-Current*, which amends IAS 1 – *Presentation of Financial Statements*. The narrow scope amendments affect only the presentation of liabilities in the statement of financial position and not the amount or timing of its recognition. It clarifies that the classification of liabilities as current or non-current is based on rights that are in existence at the end of a reporting period and specifies that classification is unaffected by expectations about whether an entity will exercise its right to defer settlement of a liability. It also introduces a definition of ‘settlement’ to make clear that settlement refers to the transfer to the counterparty of cash, equity instruments, other assets or services. The amendments are effective for annual reporting periods beginning on or after January 1, 2022. Earlier application is permitted. The Company is assessing the potential impact of these amendments.

4. Short-term investments

Short-term investments of \$6,864,359 (September 30, 2020 - \$6,849,285) consist of cashable term deposits held with a Canadian chartered bank. The term deposits have maturity dates between January 19, 2021 and June 23, 2021. Interest rates range between 0.52% and 0.58%.

Nanotech Security Corp.

Notes to the Condensed Interim Financial Statements
(Unaudited)

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5. Inventory

	December 31, 2020	September 30, 2020
Raw materials	\$ 153,085	\$ 179,034
Work in progress	63,939	30,281
Finished goods	1,395	1,400
	\$ 218,419	\$ 210,715

There were inventory write-downs of \$17,648 expensed to materials consumed during the three months ended December 31, 2020 (December 31, 2019 - \$nil).

For the three months ended December 31, 2020, the Company recognized inventories of \$22,558 (December 31, 2019 - \$143,115) as expensed through cost of sales.

6. Asset held for sale

In October 2020, the Company completed a capital project to replace a propane heating system with an electric heating system and committed to a plan to sell the propane boiler. The Company previously recorded an impairment loss to reduce the carrying value of the boiler to the recoverable amount, as measured by the expected net proceeds upon disposal. No further write-down was recorded and as at December 31, 2020, the propane boiler was reclassified from property, plant and equipment to a separate line on the balance sheet as asset held for sale.

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, 2020 and December 31, 2020	69,399,861	\$ 62,499,841

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, 2020:

	Number of options	Weighted average exercise price
Balance as at September 30, 2020	4,783,200	\$ 0.68
Granted	717,500	0.48
Balance as at December 31, 2020	5,500,700	\$ 0.66

Nanotech Security Corp.

Notes to the Condensed Interim Financial Statements
(Unaudited)

Three months ended December 31, 2020 and 2019
(In Canadian dollars)

7. Share capital (continued)

(b) Share-based payment plans (continued)

(i) Stock option plan (continued)

The following table summarizes information pertaining to the Company's stock options outstanding as at December 31, 2020:

Range of exercise prices	Options outstanding			Options exercisable	
	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	2,741,500	4.08	\$ 0.40	1,130,500	\$ 0.39
\$0.51 - \$0.75	1,487,500	3.06	0.61	1,487,500	0.61
\$1.01 - \$1.25	666,700	0.81	1.12	666,700	1.12
\$1.26 - \$1.50	605,000	1.60	1.43	605,000	1.43
	5,500,700	3.13	\$ 0.66	3,889,700	\$ 0.76

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, 2020 and 2019:

	Three months ended December 31	
	2020	2019
Risk free interest rate	0.4%	1.5%
Expected life	4.0 years	5.0 years
Expected volatility	70.7%	51.4%
Expected dividends	Nil	Nil
Average fair value	\$0.25	\$0.18

For the three months ended December 31, 2020 and 2019, 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	
	2020	2019
Total compensation - stock options	\$ 56,060	\$ 115,898

(ii) Restricted share unit plan

RSUs outstanding as at December 31, 2020:

	Number of RSUs
Balance as at September 30, 2020	284,083
Granted	265,588
Balance as at December 31, 2020	549,671

Nanotech Security Corp.

Notes to the Condensed Interim Financial Statements
(Unaudited)

Three months ended December 31, 2020 and 2019
(In Canadian dollars)

7. Share capital (continued)

(b) Share-based payment plans (continued)

(ii) Restricted share unit plan (continued)

For the three months ended December 31, 2020 and 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	
	2020	2019
Total compensation - RSUs	\$ 16,472	\$ 20,963

8. Related party transactions

For the three months ended December 31, 2020 and 2019, 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	
	2020	2019
Salaries, accrued bonuses, employee benefits and director fees	\$ 202,262	\$ 193,944
Share-based payments	29,237	79,241
	\$ 231,499	\$ 273,185

(b) As at December 31, 2020, amounts owing to directors for director fees and expense reimbursements included in accounts payable and accrued liabilities were \$13,100 (September 30, 2020 - \$58,619).

(c) On January 15, 2021, the Company purchased six patents from a company owned by a director of the Company for \$100,000 and agreed to share 10% of any revenues from a specific customer developed in the next two years with ongoing royalties of 3% to 6% on other revenues derived from the patents for a period of five years.

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) Changes in non-cash working capital

	Three months ended December 31	
	2020	2019
Accounts receivable	\$ 644,955	\$ (267,947)
Inventory	(7,674)	46,557
Prepaid expenses and other assets	43,525	71,894
Accounts payable and accrued liabilities (note 9(d))	(336,749)	(156,327)
Deposit	(10,874)	(13,000)
	\$ 333,183	\$ (318,823)

Nanotech Security Corp.

Notes to the Condensed Interim Financial Statements
(Unaudited)

Three months ended December 31, 2020 and 2019
(In Canadian dollars)

9. Supplementary cash flow information (continued)

(b) *Income taxes*

The Company did not pay any income taxes during the three months ended December 31, 2020 and 2019.

(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, 2020	September 30, 2020
Cash	\$ 800,188	\$ 1,026,845
Cash equivalents	725,744	725,010
	\$ 1,525,932	\$ 1,751,855

(d) *Supplemental disclosure of non-cash investing activities*

As at December 31, 2020, property, plant and equipment included in accounts receivable and accounts payable was \$45,768 and \$3,628 respectively (December 31, 2019 - \$nil and \$35,225).

During the three months ended December 31, 2020, deposits of \$10,168 (December 31, 2019 - \$nil) were applied to property, plant and equipment.

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	
	2020	2019
Development contracts	\$ 1,675,700	\$ 1,226,537
Products and services	36,550	243,389
	\$ 1,712,250	\$ 1,469,926

For the three months ended December 31, 2020, sales within Canada were \$nil (December 31, 2019 - \$73,254) and sales outside Canada were \$1,712,250 (December 31, 2019 - \$1,396,672).

During the three months ended December 31, 2020, the Company had one customer who represented greater than 10% of total revenues. This customer represented approximately 98% of total revenues (December 31, 2019 - one customer represented approximately 83% of total revenues).

Nanotech Security Corp.

Notes to the Condensed Interim Financial Statements
(Unaudited)

Three months ended December 31, 2020 and 2019
(In Canadian dollars)

11. Nature of expenses

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

	Three months ended December 31	
	2020	2019
Salaries and benefits	\$ 1,105,122	\$ 931,406
Share-based compensation	72,532	136,861
Depreciation and amortization	379,853	395,968
Travel and entertainment	5,353	98,504
Professional fees and insurance	248,780	242,262
Public company costs	116,736	91,990
Rent and utilities	171,148	152,687
Maintenance and office expenses	121,598	118,071
Materials consumed	140,087	86,951
	\$ 2,361,209	\$ 2,254,700

12. Finance income

	Three months ended December 31	
	2020	2019
Interest income from cash and cash equivalents and short-term investments	\$ (16,005)	\$ (46,986)
Interest paid on lease liability	10,382	11,051
Other interest expenses	2,641	2,490
	\$ (2,982)	\$ (33,445)

13. Commitments and contingencies

(a) As at December 31, 2020, the Company is committed to operating costs in respect of leased office space, contracted equipment maintenance, and equipment purchases for the following amounts:

2021	\$ 218,136
2022	262,508
2023	193,758
2024	107,208
2025	62,538
	\$ 844,148

(b) Certain nano-optic products are subject to a 3% sales royalty in favour of Simon Fraser University ("SFU") where certain elements of the nano-optic technology originated. There were no royalties during the three months ended December 31, 2020 and 2019. In 2014, the Company prepaid royalties that would offset against future royalties owed as part of the transfer of the intellectual property from SFU, of which \$197,340 remains prepaid as at December 31, 2020 (September 30, 2020 - \$197,340).

Nanotech Security Corp.

Notes to the Condensed Interim Financial Statements
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Three months ended December 31, 2020 and 2019
(In Canadian dollars)

13. Commitments and contingencies (continued)

- (c) In March 2020, the World Health Organization declared the COVID-19 outbreak a pandemic. The ultimate duration of COVID-19, the magnitude of the impact on the economy, and the full extent to which COVID-19 may have direct and indirect impacts on Nanotech's business is not known at this time. This could include an impact on the Company's ability to obtain debt and equity financing, impairment in the value of long-lived assets, or potential future decrease in revenue or the profitability of Nanotech's operations. The Company has not yet experienced any material negative impacts to its business, results of operations, or its financial position as a result of COVID-19.