



Nanotech Security Corp.

Third Quarter 2019 Results Conference Call

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

Monika Russell, *Acting Chief Financial Officer*

Troy Bullock, *President and Chief Executive Officer*

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

Gianluca Tucci, *Echelon Wealth Partners*

Anthony Prost, *GMP Securities*

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

Operator:

Good afternoon and thank you for joining us to discuss Nanotech Security Corp.'s Third Quarter 2019 Results. On the call today we have Troy Bullock, Nanotech's President and CEO, and Monika Russell, Nanotech's Acting CFO. Please be advised that today's call is being recorded. At this time all participants are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session. Instructions will be provided at that time for you to queue up.

I will now turn the call over to Monika Russell. Please go ahead.

Monika Russell:

Good afternoon and thank you for attending our Third Quarter 2019 Conference Call. Troy Bullock will begin the call today with an overview of our Q3 results and operational highlights. I will then provide a detailed review of our financial performance for the quarter. Following the financial review, Troy will provide an outlook and discussion of our goals and expectations for Fiscal 2019. Following the formal presentation, we would be pleased to take questions.

However, before we talk about results, I'd like to remind everyone that certain statements in this call may be forward-looking in nature. These include statements involving known and unknown risks, uncertainties, and other factors that could cause actual results to differ materially from those expressed or implied in our forward-looking statements. For caveats about forward-looking statements and risk factors, please see our MD&A for the year ended September 30, 2018, which can be found on our Company profile at sedar.com.

Also, as part of the Company's business involves dealing with security features for banknotes, you will appreciate that we are quite limited in our ability to provide details about specific customers and prospects. That said, we will do our best to provide Investors with general feedback we are receiving from our customers, the industry, new opportunities that we are pursuing, and give some general parameters

on how these development contracts normally advance into full deployment as security features on banknotes.

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

Troy Bullock:

Thanks, Monika, and good afternoon, everyone. Thank you for taking the time to attend our conference call for the third quarter of Fiscal 2019. I'd like to begin with an update of our corporate strategy. In January 2019 I implemented a strategic shift to focus on near-term revenue by commercializing our nanotechnology into products. I brought in seasoned sales leaders to increase customer engagement around these products and to build out a sales pipeline. I also focused our efforts into two markets, the banknote and secure documents market and the brand protection market. We are now beginning to see the results of this strategic shift.

To-date we have launched two new products into the brand protection market. We are seeing very strong interest and have been attending trade shows to gauge feedback and build up the pipeline. I'm happy with the progress we're making and can say that we are building a significant pipeline of opportunities with interested parties. As we win these new deals and opportunities, we will announce them to the marketplace, and I'm pleased with the feedback our sales team is hearing from the prospective customers.

We've also seen success in our increased sales efforts for existing products such as optical thin film or OTF. As announced on August 1, the Company secured a new order with a long-term customer for a custom OTF product that will be applied as a security feature in government-issued identification documents. This order has partially contributed to Nanotech's third quarter revenue and the balance will be delivered in Calendar '19. We anticipate this order to be recurring in nature.

In addition to these activities, we continue to make advancements with our development contract customer. Nanotech currently generates most of its revenue from contract services with a confidential central bank customer with a goal of incorporating our security feature into their banknote in the near future. In July the customer confirmed that the security feature being developed by Nanotech will advance to the next stage which involves demonstrating that the selected future technology can be manufactured in our Thurso production facility. We still do not have visibility into when Nanotech's security feature might be integrated into the customer's banknote but moving from the lab to a production setting is a major advancement. As of June 30, 2019, we have recognized half of the revenue from the \$30 million contract.

That concludes my initial comments on the strategic and operational accomplishments and I'll now pass the call back to Monika, to discuss the detailed financial results for the third quarter. Monika?

Monika Russell:

Thank you, Troy. Before I begin, I would like to mention that all the dollar amounts I refer to are in Canadian dollars unless otherwise stated.

Starting with our quarterly results, revenue for the third quarter of 2019 was \$1.9 million. Revenue was generally flat year-over-year as increased OTF sales were offset by a reduction in contract services revenue. Gross margin for the third quarter was 72% versus 83% in the third quarter of 2018, due to a lower proportion of development revenue in our revenue mix.

We continue to contain our operating costs. For the third quarter of 2019, operating costs were \$2 million, compared to \$2.1 million in the third quarter of Fiscal 2018. Net loss from continuing operations for the third quarter of 2019 was \$521,000 versus \$456,000 in the third quarter of 2018.

The difference was primarily due to lower gross margin in the current quarter in combination with foreign exchange losses in the current quarter. Adjusted EBITDA for the third quarter of 2019 was \$17,000 compared to \$100,000 in the same period of 2018. The decrease from the prior period was primarily due to lower gross margins in the current period.

Moving on to our year-to-date results, revenue for the nine months ended June 30, 2019 was \$5.5 million, down 6% from 2018. This year-over-year decrease was primarily due to the timing and scope of development contracts, partially offset by an increase in OTF revenue. Gross margin for the year-to-date was 71% versus 77% in 2018, due to a lower proportion of development revenues in our revenue mix. Operating costs were \$6.4 million for the year-to-date compared to \$5.8 million in 2018.

Excluding the restructuring cost incurred in the first quarter, operating costs are relatively flat. Net loss from continuing operations for the year-to-date was \$2.1 million versus \$693,000 in 2018. The difference was primarily due to restructuring costs associated with the executive transition in the current year, in combination with decreased revenue and margin.

Adjusted EBITDA for the year-to-date was \$180,000 compared to \$693,000 in the same period of 2018. The decrease from the prior period was primarily due to reduced revenue and margins in the current period.

The Company remains debt free and we retained our strong cash position ending the quarter with cash and short-term investments of \$9.6 million. Financially the Company remains very well capitalized to execute its business plans.

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

Troy Bullock:

Thanks, Monika. I'd like to begin by updating you on the goals we established with Fiscal '19. First the banknote market goals. The banknote market continues to be Nanotech's primary market and the Company has two areas of focus within this market. The first area of focus is contract services. As I mentioned previously, a confidential central bank customer confirmed that the security feature being developed by Nanotech under its \$30 million development contract will advance to the next stage, which involves demonstrating that the selected security feature technology can be manufactured in our Thurso production facility.

While we are excited about this major advancement, we do not yet know how this will impact our revenues going forward. The timing and scope of development activities in this next stage is expected to be agreed upon in the coming weeks and will have a direct impact on the Company's fourth quarter and Fiscal 2020 results. I will discuss this more when I talk about our guidance at the end of the call.

Our second area of focus in the banknote market is to expand and enhance our banknote product line to drive near-term revenue growth. We are on track with our development efforts for new and innovative banknote products using KolourOptik technology with an expected launch in October 2019. In addition, as part of our strategic shift to focus on sales, we added more sales resources this year and will continue to pursue new sales opportunities for the existing banknote products including optical thin film produced in our Thurso production facility.

We continue to be well positioned in the banknote market with great progress in our development project and generating new optical thin film opportunities. We anticipate our new KolourOptik product launch to be very well received towards the end of the year.

It is also important to note that the investments we have made in our Thurso production facility have increased manufacturing capabilities and enabled us to increase our optical thin film offerings. We are continuing to invest in our Thurso facility and in the fourth quarter of 2019 we will begin expanding our manufacturing footprint within the existing building in order to add equipment that will bring us closer to being able to produce a full security feature for banknote and commercial customers.

Secondly, our commercial goals. Our other major pillar growth and diversification of our revenue base is the launch of brand protection products targeted specifically at the commercial market. On April 2, the Company successfully launched its LiveLogo and Dynamic Portrait products, which allow customers to showcase their logo, tagline and products using KolourOptik technology. You can view more detail about LiveLogo and Dynamic Portrait in the Products section of Nanotech's website.

On our last call, I mentioned to you that you could expect to see new additions to our sales team. I'm pleased to welcome Chris Darling who joined as a sales executive focused on the North American commercial brand protection market. Chris is responsible for identifying, closing, and managing strategic accounts for Nanotech's commercial brand protection business and is accountable for delivering new opportunities and driving commercial brand protection revenue in North America.

During the quarter Nanotech's sales team participated in targeted industry trade shows and events to promote the Company's brand protection product line. Nanotech's products have garnered strong interest from the industry and several new opportunities in the sales pipeline. Going forward, our sales team will continue to focus on building out the sales pipeline and winning reference accounts in the brand protection market.

Moving on to our Fiscal 2019 guidance, the Company is currently in the process of determining the financial terms and scope of development work for the next stage of our contract services project, which could impact the fourth quarter and the upcoming Fiscal Year. At this time, we are leaving our annual revenue guidance unchanged and continue to expect revenue between \$7.4 million and \$8.3 million. The fourth quarter will be impacted by the timing and scope of the next phase of our development contract. As far as Adjusted EBITDA, we previously were targeting a loss of up to \$1 million. I can say that we are on track to improve upon that number.

With a strong balance sheet including \$9.6 million in cash and short-term investments and no debt the Company is well positioned to continue to develop and pursue product-based sales and marketing strategies in 2019 and position us for growth in 2020. Looking to the future, Nanotech's KolourOptik nanographic display technology offers unprecedented live colour content, visual effects, and high definition colours that redefine conventional print image. As we commercialize our technology, we are well positioned with our secure production facility to deliver highly differentiated products to both the banknote and brand protection market.

We are already well into the advancements of our commercialization strategies, and in the coming quarters, we will be continuing to make investments in our sales and marketing efforts as we continue to pursue both the banknote and brand protection market.

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

Operator:

Thank you. If you would like to ask a question, please signal by pressing star, one on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star, one to ask a question. We will pause for just a moment to allow everyone the opportunity to signal for questions.

We will now take our first question from Gianluca Tucci of Echelon Partners. Please go ahead.

Gianluca Tucci:

Hi, guys, good afternoon. I guess we'll start on the banknote side. So, in a perfect world, like what are the upcoming milestones for your development contract that have to be met, in terms of the next steps in order for them to decide that you're the incumbent security provider on their banknote?

(Cross-talking)

Troy Bullock:

Yes. Good afternoon, Gianluca. So on the banknote development contract as I described in the past, the first phase of that project was developing and demonstrating the technology and I would call it more of an R&D phase where we're demonstrating projects, and that's the phase that we've been in for the last couple of years. Through that phase, we've demonstrated to them a number of different technologies, techniques, security features, to demonstrate our capabilities and find out what they were interested in for their unique security feature.

So, this next phase that we're about to enter into is a major milestone for us where we've progressed out of that stage, and now we're into the stage where they've accepted and liked the technology, they liked the security feature direction that they're designing. Then now they would like to move into this phase where we can demonstrate production capability in our Thurso facility. So that's the phase where we're just about to enter into now. That phase typically lasts 12 to 18 months. We're just defining the scope of that with them today as to what that will mean as far as timeline, what that will mean as far as revenues, and what that will mean, as far as success gates.

Then the next and sort of final stage gate that we would like to proceed to, once we complete this phase would be for us to move into, sort of accepted to be on the banknote and integrating into their production facility. That would be the sort of the next stage that we would hope to achieve, after we complete this stage we're just entering into. And that's the stage where we would expect to be producing significant volume, almost the same as if it was full volumes in production into our released product. So that's a fairly major stage.

I mean, each of these stages are quite significant. The one we're entering into now is a huge accomplishment, and we're very excited for it, and it will definitely drive our business for next year. One more stage after that is to be actually integrated into their bank note.

Gianluca Tucci:

So thanks, Troy for that colour. That's fantastic. So of the 15 of the 30, that you book to date in terms of the development contract, is this next stage something that's on top of that, or different, or incremental?

(Cross-talking)

Troy Bullock:

Yes, at this stage, it will be part of the \$30 million. Now keep in mind that \$30 million is just a pre-approved budgetary amount that we agree on from year-to-year to draw against, if and when we complete that or draw beyond that, then we would just be working with them to expand that into a different number. So yes, we're going to continue to draw around that same pre-approved budget. If and when we start to exceed that, we will just work with them to increase that amount.

Gianluca Tucci:

Right, and it's fair to assume that at this—I guess, a second phase of development that they've accepted, and like your technology and you demonstrate your production capability, and capacity is fair to assume that your quarterly like run rate or your quarterly activity should increase against the first stage of the R&D phase, right?

Troy Bullock:

I've got to be careful in that because that is a step—that is what we're negotiating with them now. What the discussion really is they're confirming how much resources they have on their side and their internal budget spend for the next 12 months. That's going to drive revenue for us versus timeline to complete. So yes, the scope of runway should be higher, and it should result in more revenue coming our way. But that also could be impacted from their side by them saying, well, instead of 12 months, maybe we've got to do it over 18 months, because they haven't got the budget ready for it in the next 12 months.

So that's the exercise we're going through right now is to figure out how much they're prepared to take on over the next 12-month period. But I am expecting and hoping that it is going to be a higher run rate than what we've had this past year.

Gianluca Tucci:

Okay, great. Thank you. I'll turn gears over to your OTF announcement that you, I think announced last week it was. So I think the press release did mention that it's for the colour shifting patch, and it's used to authenticate government issued IDs. So is it safe to assume that this is a government agency customer and long-term contract? I guess as a follow-up to that, like what are the types of volumes that could be associated with this contract?

Troy Bullock:

Yes, so thanks, Gianluca. This customer that we're working with is actually what I would describe more as an OEM. They are a customer that produces full products, likely produces the full government ID itself, and is sourcing the optical thin film from us to supply to that. So we're one step away from the government, that government or governments that he's supplying this ID to. Our understanding at this stage is that this will likely be a recurring order. But I can't give much—we don't have much visibility to what countries they're working with and what sort of volume they're taking this material into, as far as specific ideas. That's something that they want to keep very proprietary to themselves and obviously, they don't want to start announcing to the public, who's buying what from them, because that might jeopardize their business.

But we're quite excited about it from our side, because as you know, we've always had this optical thin film. We've typically sold it in the banknotes, we've pursued other markets, like government IDs, and things like that, and to bring on some new business, which is growth for us, that is typically recurring, starts to show some expansion in that area for us.

Gianluca Tucci:

Fantastic. Thanks, Troy, and I also agree that it is a significant announcement. Then just lastly, on my part here, can you give us an update on your sales and marketing, commercial transformation, and some of the things that are still to be done for the balance of 2019?

Troy Bullock:

Yes, there's a lot of activity going on. There has been over the last six months, it's quite a transformation. We're working right now on 2020's plan, but it's equally as aggressive. Maybe just to kind of back up a little bit and kind of reiterate some of the steps that we've taken in the year. We've set out this year to focus on near term revenue. That was really the underlying theme of what we were doing. To do that we needed to develop products that we could sell today and build out a sales force to do that.

I was pleased that in the first 90 days between January and March, we set out to build out a North American supply chain that would give us the ability to produce products. We launched two products at the end of March, early April, targeted specifically for that brand protection space. Following that we've added some salespeople, we added a Vice President of Sales early in the year, Brian Donnelly, who's tremendous, and he's got a 15, 20-year resume of selling technology products to international customers. We've since added Chris Darling, who came from the industry selling into brand protection, and he's been selling holograms in that space for 15 years.

Chris and Brian have been targeting that brand protection market, since April, May when Chris came on board. In that short period time frame, they visited many trade shows, they've met with dozens and dozens of customers. I'm actually pretty pleased with the progress because the feedback we're getting from these trade shows is very positive. We're getting positive feedback on the designs of these products. We're also starting to build out our pipeline. I mean, it's not something that I want to draw a huge amount of focus to at this time, but when you launch a product as late as 90 days ago and start to see already that we're starting to see more than a dozen qualified opportunities in our sales funnel, we're excited about that. We're starting to think that, that does have some real traction.

So, as we move forward, and we start to get into the next phase, we're still going to focus on that near-term revenue. Our goal now is to add more things that we can sell right now. So in the product side, for the brand protection space, we've already, along with our design in our product, we've got the ability now to sell our products as a PSA label, which is more like a sticker, if you will, and we have the ability to add-on to that QR code serialization features and tamper resistant materials, and quote on customers that we can deliver that in six to eight weeks.

As we move forward, we're going to start to add-on things like hang tags, and track and trace and things like that. So that again, we have more things to sell, that can drive revenue to these customers right away. Same sort of approach in the banknote space, where we're targeting banknote market. So we want to make sure that we're having things that we can sell today, the optical thin film, branding so we can start to take that into new markets, and then coming out with new products in the banknote space that we can start to sell today that can have a sales cycle of 12 months for the banknote space as opposed to something that might take four or five years that we were pursuing before.

So really a theme of near-term revenues, producing products and salespeople and targeting building our sales pipeline out right away.

Gianluca Tucci:

Okay, thank you, Troy, and sorry, just one more on your gross margins. So small uptick sequentially against your Q2, what caused that uptick and as your OTF order starts to be delivered, how should we be thinking about your consolidated margins going forward? Thank you.

Troy Bullock:

Yes, Gianluca, I always have to be careful in our margins just because of competitive reasons and when ensuring our customers and our salespeople are not going to be offended by something that I may or may announce publicly. What I can say is we've enjoyed pretty strong margins typically in the 70% to 80% range over the last number of years. That's obviously going to be heavily dependent on the mix, whether it's a contracting services revenue, whether that's revenue from brand protection, or whether that's revenue for optical thin film. So as that mix changes, it does fluctuate in that range. I think we've just said that we do continue to expect to have high margins consistent with what we've been seeing before. But it will fluctuate quarter-to-quarter, sort of in that range that we've been enjoying to this point.

Gianluca Tucci:

Okay, thanks, Troy, and keep up the good work, guys. Thanks.

Troy Bullock:

Thanks, Gianluca, have a good evening.

Operator:

If you find that your question has been answered you may remove yourself from the queue by pressing star, two. Once again if you would like to ask a question please signal by pressing star, one.

We will now take our next question from Anthony Prost of GMP Securities. Please go ahead.

Anthony Prost:

Good afternoon, Anthony on behalf of Ben Jekic. Just wanted to first of all follow-up on a question of Gianluca's. So in terms of qualifying for this large client, I mean, obviously, hitting, a high-quality product and certain volumes is good. But is there any other element that you think might be part of the qualification process? Like, especially is there anything that might require any sort of facility upgrades?

Troy Bullock:

Yes, just to be clear, you're talking about our development contract or contracting services work right, Anthony?

Anthony Prost:

That's correct. Yes.

Troy Bullock:

Yes. So again, the scope of the work is, really what we're working with the Central Bank customer right now, what I can say is, the general focus of the work is that they want to see that this image that we've

created can be produced in a production environment. In our Thurso facility right now, as you've seen, I know you've been to visit the facility you and Ben, that facility has—we've got lots of space there. We're able to expand into that facility to take on more equipment. We've got certain production equipment in that building today, where we're able to do casting lines and metalization and certain things like that. There are a few pieces of equipment that we do need to add to that facility to build out a full security feature. But that's something fortunately, we've been able to gain the support from our Central Bank partner, we're in effect, having them pay for a lot of that equipment.

We are talking about three pieces of equipment. We do have to incur some costs on our side. I think we've targeted somewhere in that \$300,000 to \$500,000 range, which is largely going to be renovation type work to bring the equipment in. But we see that taking place in literally over the next sort of 60 days to set us up and put us in a position where we can receive this new equipment and start to do that production work.

As far as the hurdles for being successful in this next phase, I think to a large extent, I mean, we've been proving out as we went along, that the technology can be manufactured. It's really now just building that out into something where we can produce it into more volume. So we're pretty comfortable that the process unfolds quite routinely, if you will, but there is an exercise of tasks and steps and proving things out from durability to ensuring the adhesives work and things like that, that we would need to go through in this next phase to prove out the success of the product.

Anthony Prost:

Right. That's great colour. Thank you. Also, so just remind me, as far as your Indian tax stamp opportunity, has that, has that sort of fallen by the wayside or —?

Troy Bullock:

Yes, so there's a couple of points to that. Our focus this year has been to work towards near term revenue. I mean that's the theme I use internally here over and over is what can we build today that we can sell today to build out our revenue base. We've got a good relationship with a couple of partners in India, that are manufacturers that wanted to build out their manufacturing capability and demonstrate that they can produce our product and then they wanted to sell it into the Indian market, both tax stamps but also into the commercial market and selling products there.

A lot of the focus over the last year with them from their side has been upgrading and changing and—tinkering's may be too strong a word but playing with their manufacturing side of things. Since June, we've had a number of conversations with them to really refocus them away from working on their manufacturing side, because we can produce it for them, we can demonstrate that the product can be made. We're making it here. We've got a North American supplier; all that stuff is in place already. We want them focused on selling. We want them to go out and find customers, build out a pipeline and demonstrate that there's a demand there in that market for the products that we have. We're hopeful that we see that because we're seeing that in North America, within—90 days we have showing our products, and we're seeing strong demand.

I think in the Indian market, we want them to take that same approach. So the change in focus with them has been, let's focus a little less on designing some unique thing that going to have a long sales cycle into, we've got product offering that's available for sale today that can be produced in short-term, let's go out and find ourselves some customers. One of the differences I would also add from years past, we historically have had, one, two, three customer opportunities, India certainly being one that we would talk about each quarter. I want to move away from that. Now that we've got more salespeople, I want to see a

sales funnel. Already we've got, over a dozen in the brand protection space, and we've got more than that or about the same in the banknote space, and that's just after 90 days.

We need to get that number up into the hundreds, so we've got multiple streams and markets of activities and we're not reliant on just any one particular party. So, at this point in time, I don't have anything in the sales funnel for the India market. We've got them focused, and I'm hopeful that we will get some things in the sales funnel in the next coming months and quarters. But we're not reliant on that business at all. We're focused on driving our own revenues and building up that sales pipeline.

Anthony Prost:

Perfect, Appreciate it. Then just a few housekeeping items here. So first of all, on this OTF, this new client that you announced in just the last week or two, can you repeat one more time what the timing would be on that one?

Troy Bullock:

Yes, so we announced that I guess going back a couple weeks ago, and we've been shipping some product in this in immediately before that, as well as through this quarter. Then there's a little bit that spills over into sort of October-November timeframe. It all ships before the—the bulk of it is in this quarter and the balance between the end of the year. I haven't disclosed publicly what that dollar amount is. Our customers asked us not to for competitive reasons. So I haven't really given the financial terms. But it's really basically made up of about four different deliveries, one or two that have happened and one late in this quarter and one early in Q1 of next year, which is like October, November timeframe.

Anthony Prost:

All right, perfect. Lastly, I think we discussed last quarter about the impact of IFRS 16? Do you have any updates on that? Or are you still waiting until year end before—like the end of your Fiscal Year before you start providing any sort of colour on the impact of IFRS 16?

Monika Russell:

Hi, Anthony. It's Monika here. This past quarter, we scoped out the leases that will be affected by this and then there are office leases. We haven't done the quantitative analysis yet, but we're really not expecting that this is going to be a super significant thing.

Anthony Prost:

Right. Perfect. Thank you so much. That's all for me.

Troy Bullock:

Thanks, Anthony. Have a good evening.

Operator:

It appears there are no further questions that this time. I'd like to turn the conference back to you for any additional or closing remarks.

Troy Bullock:

Thank you. I would like to thank everyone for your questions and for joining us for our third quarter conference call. We were pleased with financial results and feel confident in our go forward strategy to expand our sales team, launch new products and diversify beyond the contract services revenue in the banknote market. I look forward to updating everybody on our continued progress on the next call. I'll turn the call back over to the Operator for closing details. Thank you everyone.

Operator:

This concludes today's call. Thank you for your participation. You may now disconnect.