

Report to shareholders

Second quarter

Six month period ended August 31, 2019



Velan. Quality that lasts.

VELAN

Management's Discussion and Analysis

2nd QUARTER ENDED AUGUST 31, 2019

October 10, 2019

The following discussion provides an analysis of the consolidated operating results and financial position of Velan Inc. ("the Company") for the quarter ended August 31, 2019. This Management's Discussion and Analysis ("MD&A") should be read in conjunction with the Company's audited consolidated financial statements for the years ended February 28, 2019 and 2018. The Company's consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). The significant accounting policies upon which these consolidated financial statements have been prepared are detailed in Note 2 and 3 of the Company's audited consolidated financial statements. All foreign currency transactions, balances and overseas operations have been converted to U.S. dollars, the Company's reporting currency. Selected annual information for the three most recently completed reporting periods and a summary of quarterly results for each of the eight most recently completed quarters are included further in this report. Additional information relating to the Company, including the Annual Information Form and Proxy Information Circular, can be found on SEDAR at www.sedar.com.

BASIS OF PRESENTATION AND ANALYSIS

The basis of presentation of the Company's second quarter unaudited condensed consolidated financial is detailed in Note 1 of the Company's audited consolidated financial statements for the years ended February 28, 2019 and 2018. The Company has adopted IFRS 16 as of March 1, 2019 (see *Accounting standards and amendments adopted in the period* section).

In this MD&A, the Company has presented measures of performance or financial condition which are not defined under IFRS ("non-IFRS measures") and are, therefore, unlikely to be comparable to similar measures presented by other companies. These measures are used by management in assessing the operating results and financial condition of the Company and are reconciled with the performance measures defined under IFRS. Reconciliations of these amounts can be found at the end of this report.

FORWARD-LOOKING INFORMATION

This MD&A may include forward-looking statements, which generally contain words like "should", "believe", "anticipate", "plan", "may", "will", "expect", "intend", "continue" or "estimate" or the negatives of these terms or variations of them or similar expressions, all of which are subject to risks and uncertainties. These risks and uncertainties are disclosed in the Company's filings with the appropriate securities commissions. While these statements are based on management's assumptions regarding historical trends, current conditions and expected future developments, as well as other factors that it believes are reasonable and appropriate in the circumstances, no forward-looking statement can be guaranteed and actual future results may differ materially from those expressed herein. The Company disclaims any intention or obligation to update or revise any forward-looking statements contained herein whether as a result of new information, future events or otherwise, except as required by the applicable securities laws. The forward-looking statements contained in this report are expressly qualified by this cautionary statement.

OVERVIEW

The Company designs, manufactures and markets on a worldwide basis a broad range of industrial valves for use in most industry applications including power generation, oil and gas, refining and petrochemicals, chemicals, LNG and cryogenics, pulp and paper, geothermal processes and shipbuilding. The Company is a world leader in steel industrial valves operating 13 manufacturing plants worldwide with 1,827 employees. The Company's head office is located in Montreal, Canada. The Company's business strategy is to design, manufacture, and market new and innovative valves with emphasis on quality, safety, ease of operation, and long service life. The Company's strategic goals include, but are not limited to, customer-driven operational excellence and margin improvements, accelerated growth through increased focus on key target markets where the Company has distinct competitive advantages and continuously improving and modernizing its systems and processes.

Management's Discussion and Analysis

The consolidated financial statements of the Company include the North American operations comprising three manufacturing plants in Canada, as well as one manufacturing plant and one distribution facility in the U.S. Significant overseas operations include manufacturing plants in France, Italy, Portugal, Korea, Taiwan, India, and China. The Company's operations also include a distribution facility in Germany and a 50%-owned Korean foundry.

CONSOLIDATED HIGHLIGHTS¹

(millions, excluding per share amounts)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Increase (decrease)	% Increase (decrease)
Consolidated statements of earnings				
Sales	\$85.5	\$91.4	\$(5.9)	(6.5)%
Gross profit	22.0	19.3	2.7	14.0%
Gross profit %	25.7%	21.1%		
EBITDA ²	5.2	1.4	3.8	271.4%
EBITDA ² %	6.1%	1.5%		
EBITDA ² per share – basic and diluted	0.24	0.06	0.18	300.0%
Net earnings (loss) ³	1.4	(2.4)	3.8	158.3%
Net earnings (loss) ³ %	1.6%	(2.6)%		
Net earnings (loss) ³ per share – basic and diluted	0.06	(0.11)	0.17	154.5%
Weighted average shares outstanding	21.6	21.6		
Consolidated statements of cash flows				
Cash provided by operating activities	1.2	3.1	(1.9)	(61.3)%
Cash used by investing activities	(4.0)	(2.7)	(1.3)	(48.1)%
Cash used by financing activities	(0.8)	(0.7)	(0.1)	(14.3)%
Demand data				
Net new orders received	90.7	103.5	(12.8)	(12.4)%
Period ending backlog of orders	425.6	469.0	(43.4)	(9.3)%

¹ All dollar amounts in this schedule are denominated in U.S. dollars.

² Non-IFRS measures – see reconciliations at the end of this report

³ Net earnings or loss refers to net income or loss attributable to Subordinate and Multiple Voting Shares.

Management's Discussion and Analysis

(millions, excluding per share amounts)	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018	Increase (decrease)	% Increase (decrease)
Consolidated statements of earnings				
Sales	\$169.3	\$169.2	\$0.1	0.1%
Gross profit	38.1	37.1	1.0	2.7%
Gross profit %	22.5%	21.9%		
EBITDA ¹	0.9	(0.1)	1.0	1000.0%
EBITDA ¹ %	0.5%	(0.1)%		
EBITDA ¹ per share – basic and diluted	0.04	(0.01)	0.05	500.0%
Net loss ²	(4.5)	(6.2)	1.7	27.4%
Net loss ² %	(2.7)%	(3.7)%		
Net loss ² per share – basic and diluted	(0.21)	(0.28)	0.07	25.0%
Weighted average shares outstanding	21.6	21.6		
Consolidated statements of cash flows				
Cash provided (used) by operating activities	3.0	(3.2)	6.2	193.8%
Cash used by investing activities	(4.8)	(4.2)	(0.6)	(14.3)%
Cash used by financing activities	(2.8)	(3.4)	0.6	17.6%
Demand data				
Net new orders received	154.9	189.7	(34.8)	(18.3)%
Period ending backlog of orders	425.6	469.0	(43.4)	(9.3)%

¹ Non-IFRS measures – see reconciliations at the end of this report

² Net earnings or loss refers to net income or loss attributable to Subordinate and Multiple Voting Shares

Management's Discussion and Analysis

Highlights *(unless otherwise noted, all amounts are in U.S. dollars and all comparisons are to the same period in the prior fiscal year)*

Results for the quarter ended August 31, 2019

- Sales amounted to \$85.5 million, a decrease of \$5.9 million or 6.5% from the prior year. Sales were negatively impacted by decreased shipments of certain large project orders in the Company's North American and French operations due to customer-related issues and the timing of the delivery schedule for such orders, partially offset by an increase in shipments of large project orders in the Company's Italian operations due to a record backlog of shippable orders at the beginning of the year. The decrease of sales in the Company's French operations is due to the timing of the deliveries of certain of its large project orders which are scheduled in the latter part of the fiscal year.
- Gross profit percentage increased by 460 basis points from 21.1% to 25.7%. The increase in the gross profit percentage is mainly attributable to a stronger proportion of higher margin product sales and an increased sales volume in the Company's Italian operations, which allowed the subsidiary to cover its fixed costs more efficiently. This increase was partially offset by temporary or non-recurring factors such as delays in shipments in the Company's French operations and a less efficient product mix in the Company's North American project manufacturing business. The Company has noted an increase in the gross profit percentage of its North American operations in comparison to the first quarter of the current fiscal year. The increase is primarily attributable to its MRO business.
- Net earnings¹ amounted to \$1.4 million or \$0.06 per share compared to a net loss of \$2.4 million or \$0.11 per share last year. The Company's return to profitability for the quarter was achieved through improved margins as well as lowered administration costs of \$1.4 million, partially offset by a lower sales volume.
- EBITDA² amounted to \$5.2 million or \$0.24 per share compared to \$1.4 million or \$0.06 per share last year. The \$3.8 million improvement in EBITDA² is primarily attributable to a stronger gross margin percentage due to the shipment of higher margin orders combined with a reduction of administration costs, partially offset by an overall lower sales volume.
- Net new orders received ("bookings") amounted to \$90.7 million, a decrease of \$12.8 million or 12.4% compared to last year. This decrease is primarily attributable to lower order bookings by the Company's Italian operations, which had record large project orders in the prior year. The Company's project quotation activity has notably increased this year in sectors where margins are healthy, and concurrently decreased in other sectors where the Company experiences the most aggressive competition and where margins are much tighter. The shift is the result of deliberate screening that is expected to take effect gradually as the Company replaces its existing backlog with higher margin orders. The net decrease in bookings experienced in the last six months, which the Company's plan aims to reverse, must be understood in this context.

Results for the six-month period ended August 31, 2019

- Sales amounted to \$169.3 million, an increase of \$0.1 million or 0.1% from the prior year. When compared to the prior half year period, the lower sales volume in the second quarter combined with the higher shipments of the first quarter left sales flat to the level of the prior fiscal year. The increased shipments of certain large project orders booked in the prior fiscal year by the Company's Italian operations was offset by the lowered sales volume recognized in the French and North American operations of the Company.
- Gross profit percentage increased by 60 basis points from 21.9% to 22.5%. This improvement is due to a higher sales volume and a stronger proportion of higher margin product sales in the Company's Italian operations, partially offset by a lower sales volume and a less efficient product mix in the Company's French and North American operations. Overall, the Company is still delivering its backlog which means that the margins do not yet reflect the impact of the number of measures launched in the last quarter under the Company's V20 transformation plan. The combined effect of these measures is expected to gradually take effect in the course of this fiscal year and next year but the greater impact of the Company's transformative V20 initiatives is only expected late in fiscal

¹ Net earnings or loss refers to net income or loss attributable to Subordinate and Multiple Voting Shares.

² Non-IFRS measures – see reconciliations at the end of this report.

Management's Discussion and Analysis

year 2021, when the task of reorganizing and reducing the Company's North American footprint is planned to be completed.

- Net loss¹ amounted to \$4.5 million or \$0.21 per share compared to \$6.2 million or \$0.28 per share last year. The \$1.7 million improvement is primarily attributable to a higher gross profit percentage, lowered finance costs and a higher recovery of income taxes.
- EBITDA¹ amounted to \$0.9 million or \$0.04 per share compared to a negative \$0.1 million or \$0.01 per share last year. The \$1.0 million increase in EBITDA¹ is mainly attributable to the improved margin in the current fiscal year.
- Bookings amounted to \$154.9 million, a decrease of \$34.8 million or 18.3% compared to last year. This decrease is due primarily to lower order bookings by the Company's North American operations which had seen an unusually high surge of non-project valve re-stocking orders from its distributors in the first quarter of the prior fiscal year. MRO distributor orders this fiscal year are expected to reflect a more normalized stock replenishment cycle. The decrease is also due to lower large project orders booked by the Company's Italian operations which had record project orders in the prior year.
- The Company ended the period with a backlog of \$425.6 million, a decrease of \$24.1 million or 5.4% since the beginning of the current fiscal year. The decrease in backlog is primarily attributable to the weak book-to-bill ratio of 0.91 in the quarter and the weakening of the euro spot rate against the U.S. dollar over the course of the current fiscal year.
- Administration costs amounted to \$43.5 million, a decrease of \$0.2 million or 0.5% compared to last year. The decrease in administration costs was achieved despite the recording of a \$0.9 million provision regarding the settlement of a product claim that was filed against the Company in a prior fiscal year (see *Contingencies* section) and a \$1.0 million investment in the Company's transformation and reorganization initiative, V20, which was announced during the prior fiscal year. Excluding these costs, the reduction in administration costs is mainly attributable to the higher freight charges that were incurred in the prior fiscal year in order to air freight a large delayed order.
- The Company ended the period with net cash of \$34.9 million, a decrease of \$6.0 million or 14.7% since the beginning of the fiscal year. This decrease is primarily attributable to investments in property, plant and equipment, long-term debt and lease liabilities repayments, as well as to distributions to shareholders via dividends, partially offset by cash provided by operating activities and an increase in long-term debt. Net cash was also negatively impacted by the weakening of the euro spot rate against the U.S. dollar over the course of the current year.
- Foreign currency impacts:
 - Based on average exchange rates, the euro weakened 5.6% against the U.S. dollar when compared to the same period last year. This resulted in the Company's net profits and bookings from its European subsidiaries being reported as lower U.S. dollar amounts in the current quarter.
 - Based on average exchange rates, the Canadian dollar weakened 2.5% against the U.S. dollar when compared to the same period last year. This resulted in the Company's Canadian dollar expenses being reported as lower U.S. dollar amounts in the current quarter.
 - The net impact of the above currency swings did not have a significant impact on the Company's net loss².

¹ Non-IFRS measures – see reconciliations at the end of this report.

² Net earnings or loss refers to net income or loss attributable to Subordinate and Multiple Voting Shares.

Management's Discussion and Analysis

SUMMARY OF QUARTERLY RESULTS

Summary financial data derived from the Company's unaudited financial statements from each of the eight most recently completed quarters are as follows:

For the quarters in months ending May, August, November and February
(in thousands of U.S. dollars, excluding per share amounts)

	QUARTERS ENDED							
	August 2019	May 2019	February 2019	November 2018	August 2018	May 2018	February 2018	November 2017
Sales	\$85,467	\$83,816	\$105,345	\$92,271	\$91,375	\$77,874	\$102,607	\$87,738
Net earnings (loss) ¹	1,369	(5,824)	1,519	(236)	(2,438)	(3,727)	(8,221)	305
Net earnings (loss) ¹ per share								
- Basic	0.06	(0.27)	0.07	(0.01)	(0.11)	(0.17)	(0.38)	0.02
- Diluted	0.06	(0.27)	0.07	(0.01)	(0.11)	(0.17)	(0.38)	0.02

Sales can vary from one quarter to the next due to the timing of the shipment of large project orders. Sales were higher in the quarters ended in February 2018 and August 2018 due to increased shipments of such orders, while the lower sales amounts for the quarters ended in November 2017 and May 2018 were due to delayed execution on the shipments of such orders. Sales were lower for the quarters ended in May 2019 and August 2019 due to the timing of the deliveries of certain large project orders scheduled for the later part of the fiscal year. Sales were higher in the quarters ended in February 2019 and November 2018 due to increased shipments of large project orders but also an improvement in the MRO business. Net earnings¹ for the quarter ended in February 2019 was higher due to an improved sales volume and a more profitable product mix. The net loss¹ for the quarter ended in May 2019 was due to a less profitable product mix partly caused by the shipment of technically complex orders with lower margins. Net earnings¹ for the quarters ended November 2017 and August 2019 was due to a more profitable product mix. The net loss¹ for the quarters ended in August 2018 and November 2018 are largely due to the fact that the North American operations were still below break even and additional costs were incurred in the quarter to meet delivery commitments. The net loss¹ for the quarters ended in February 2018 and May 2018 was due to a less profitable product mix and shipping delays caused by internal operational issues. The quarter ended in February 2018 also had a \$4.3 million one-time income tax charge resulting from the U.S. tax reform legislation passed in December 2017.

RESULTS OF OPERATIONS – comparison of three and six month periods ended August 31, 2019 and 2018 (unless otherwise noted, all amounts are in U.S. dollars and all comparisons are to same period in the prior fiscal year)

Sales

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Sales	\$85.5	\$91.4	\$169.3	\$169.2

Sales decreased by \$5.9 million or 6.5% for the quarter and increased by \$0.1 million or 0.1% for the half year. Quarterly sales were negatively impacted by decreased shipments of certain large project orders in the Company's North American and French operations due to customer-related issues and the timing of the delivery schedule for such orders, which was partially offset by an increase in shipments of large project orders in the Company's Italian operations due to a record backlog of shippable orders at the beginning of the year. When compared to the prior half year, the lower sales volume in the second quarter combined with the higher shipments of the first quarter left sales flat to the level of the prior fiscal year.

¹ Net earnings or loss refers to net income or loss attributable to Subordinate and Multiple Voting Shares.

Management's Discussion and Analysis

The decrease of sales in the Company's French operations is due to the timing of the deliveries of certain of its large project orders which are scheduled in the latter part of the fiscal year.

Net bookings and backlog

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Net bookings	\$90.7	\$103.5	\$154.9	\$189.7

Bookings decreased by \$12.8 million or 12.4% for the quarter and \$34.8 million or 18.3% for the half year. The decrease for both periods is due to lower project orders booked by the Company's Italian operations which had recorded significant project orders in the prior year. The decrease for the half year period is also due primarily to lower order bookings by the Company's North American operations which had seen an unusually high surge of non-project valve re-stocking orders from its distributors in the first quarter of the prior fiscal year. MRO distributor orders this fiscal year are expected to reflect a more normalized stock replenishment cycle. As competition remains fierce, the Company is continuing to shift its focus and target discrete market segments where its products enjoy a competitive advantage based upon its good reputation for quality. These conditions provide better pricing power for the Company which should ultimately lead to improved margins.

(millions)	August 2019	February 2019	August 2018
Backlog	\$425.6	\$449.7	\$469.0
For delivery within the next twelve months	\$284.2	\$299.6	\$306.0
For delivery beyond the next twelve months	\$141.4	\$150.1	\$163.0
Percentage – beyond the next twelve months	33.2%	33.4%	34.8%

As a result of sales outpacing bookings in the current quarter, the Company's book-to-bill ratio was 0.91 for the period. Furthermore, the total backlog decreased by \$24.1 million or 5.4% since the beginning of the fiscal year, settling at \$425.6 million. The backlog was negatively impacted by the weaker book-to-bill ratio and the weakening of the euro spot rate against the U.S. dollar over the course of the current quarter. The Company's quotation activity has notably increased this year in its severe service business, where margins are healthy, and concurrently decreased in its project manufacturing business where the Company experiences the most aggressive competition and where margins are much tighter. The shift is the result of deliberate screening that is expected to take effect gradually as the Company replace its existing backlog with higher margin orders. The net decrease in bookings experienced in the last six months, which the Company's plan aims to reverse, must be understood in this context.

Management's Discussion and Analysis

Gross profit

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Gross profit	\$22.0	\$19.3	\$38.1	\$37.1
Gross profit percentage	25.7%	21.1%	22.5%	21.9%

Gross profit increased by \$2.7 million for the quarter and \$1.0 million for the half year. The gross profit percentage increased by 460 basis points for the quarter and 60 basis points for the half year. The increase in the gross profit percentage is mainly attributable to improved margins in the Company's North American operations, as well as a stronger proportion of higher margin product sales and an increased sales volume in the Company's Italian operations, which allowed the subsidiary to cover its fixed costs more efficiently. This increase was partially offset by temporary or non-recurring factors such as a delay in shipments in the Company's French operations and a less efficient product mix in the Company's North American project manufacturing business. Overall, the Company is still delivering a backlog that dates back to the prior fiscal year, which means that the margins do not yet reflect the impact of the number of measures launched in the last quarter under the Company's V20 transformation plan. The combined effect of these measures is expected to gradually take effect in the course of this fiscal year and next year but the greater impact of the Company's transformative V20 initiatives is only expected late in fiscal year 2021, when the task of reorganizing and reducing the Company's North American footprint is planned to be completed.

Administration Costs

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Administration costs*	\$20.0	\$21.4	\$43.5	\$43.7
As a percentage of sales	23.4%	23.4%	25.7%	25.8%
*Includes asbestos-related costs of:	\$1.3	\$1.4	\$3.3	\$3.7

Administration costs decreased by \$1.4 million, or 6.5% for the quarter and \$0.2 million or 0.5% for the half year. The decrease in administration costs for the quarter and the half year was achieved despite the recording of a \$0.9 million provision, in the first quarter of the current fiscal year, regarding the settlement of a product claim that was filed against the Company in a prior fiscal year (see *Contingencies* section) and \$0.5 million investments, in each quarter of the current fiscal year, in the Company's transformation and reorganization initiative, V20, which was announced last year. Excluding these costs, the reduction in administration costs is mainly attributable to the higher freight charges that were incurred in the prior fiscal year in order to air freight a large delayed order. Furthermore, costs associated with the Company's ongoing asbestos litigation (see *Contingencies* section) decreased by \$0.1 million in the quarter and \$0.4 million for the half year period. The fluctuation in asbestos costs is due more to the timing of settlements rather than to changes in long-term trends.

Like many other U.S. valve manufacturers, two of the Company's U.S. subsidiaries have been named as defendants in a number of pending lawsuits brought on behalf of individuals seeking to recover damages for their alleged asbestos exposure. These lawsuits are related to products manufactured and sold in the past. Management believes that any asbestos was incorporated entirely within the product in such a way that it would not allow for any ambient asbestos during normal operation, inspection or repairs. Management strongly believes its products, which were supplied in accordance with valve industry practice and customer mandated specifications, did not contribute to any asbestos-related illness. The Company will continue to vigorously defend against these claims but given the ongoing course of asbestos litigation in the U.S. and the unpredictability of jury trials, it is not possible to make an estimate of any settlement costs and legal fees.

Management's Discussion and Analysis

Finance costs (income)

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Net finance costs (income)	\$(0.2)	\$0.6	\$0.1	\$0.6

Net finance costs decreased by \$0.8 million for the quarter and \$0.5 million the half year period. The reduction of finance costs for the quarter and the half year period is mainly attributable to a non-recurring interest income on a tax refund in the Company's North American operations. The Company's adoption of IFRS 16 caused a \$0.2 million increase for the half year period since the Company elected the modified retrospective transition method whereby comparative balances have not been restated.

Income taxes

(in thousands, excluding percentages)	Three-month period ended August 31, 2019		Three-month period ended August 31, 2018	
	\$	%	\$	%
Income tax at statutory rate of 26.7%	579	26.7	(710)	26.7
<u>Tax effects of:</u>				
Difference in statutory tax rates in foreign jurisdictions	404	18.6	358	(13.5)
Non-deductible (taxable) foreign exchange loss (gain)	93	4.3	309	(11.6)
Losses not tax effected (Losses utilized not previously tax effected)	(99)	(4.6)	(66)	2.5
Benefit attributable to a financing structure	(222)	(10.2)	(224)	8.4
Other permanent differences	96	4.4	229	(8.6)
Provision for (Recovery of) income taxes	851	39.3	(104)	3.9
	Six-month period ended August 31, 2019		Six-month period ended August 31, 2018	
(in thousands, excluding percentages)	\$	%	\$	%
Income tax at statutory rate of 26.7%	(1,459)	26.7	(1,911)	26.7
<u>Tax effects of:</u>				
Difference in statutory tax rates in foreign jurisdictions	366	(6.7)	649	(9.1)
Non-deductible (taxable) foreign exchange loss (gain)	422	(7.7)	241	(3.4)
Losses not tax effected (Losses utilized not previously tax effected)	(48)	0.9	459	(6.4)
Benefit attributable to a financing structure	(444)	8.1	(451)	6.3
Other permanent differences	195	(3.6)	80	(1.1)
Recovery of income taxes	(968)	17.7	(933)	13.0

A separate estimated average annual tax rate is determined for each taxing jurisdiction and applied to their respective interim pre-tax income.

Management's Discussion and Analysis

Net loss¹ and EBITDA²

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Net earnings (loss) ¹	\$1.4	\$(2.4)	\$(4.5)	\$(6.2)
As a percentage of sales	1.6%	(2.6)%	(2.7)%	(3.7)%
EBITDA ²	\$5.2	\$1.4	\$0.9	\$(0.1)
As a percentage of sales	6.1%	1.5%	0.5%	(0.1)%

EBITDA² for the quarter amounted to a \$5.2 million or \$0.24 per share compared to \$1.4 million or \$0.06 per share last year. EBITDA² for the half year amounted to \$0.9 million or \$0.04 per share compared to a negative \$0.1 million or \$0.01 per share last year. The improvements in EBITDA² for the quarter was due to a higher gross margin percentage and a reduction of administration costs, partially offset by an overall lower sales volume. The increase in EBITDA² for the half year period was due to the Company's improved margins. Net earnings¹ for the quarter amounted to \$1.4 million or \$0.06 per share compared to net loss¹ of \$2.4 million or \$0.11 per share last year. The Company's return to profitability for the quarter was achieved through improved margins as well as lowered administration costs of \$1.4 million, partially offset by a lower sales volume. The \$1.7 million improvement for the half year period is primarily attributable to a higher gross profit percentage, lowered finance costs and a higher recovery of income taxes.

¹ Net earnings or loss refers to net income or loss attributable to Subordinate and Multiple Voting Shares.

² Non-IFRS measures – see reconciliations at the end of this report

Management's Discussion and Analysis

LIQUIDITY AND CAPITAL RESOURCES – a discussion of liquidity risk, credit facilities, cash flows and proposed transactions *(unless otherwise noted, all dollar amounts are denominated in U.S. dollars)*

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due. The Company manages its liquidity risk by continually monitoring its future cash requirements. Cash flow forecasting is performed in the operating entities and aggregated by the Company's corporate finance team. The Company's policy is to maintain sufficient cash and cash equivalents and available credit facilities in order to meet its present and future operational needs.

The following table presents the Company's financial obligations identified by type and future contractual dates of payment:

(In thousands)

	August 31, 2019				
	Total	Less than	1 to 3	4 to 5	After
	\$	1 year	Years	Years	5 years
		\$	\$	\$	\$
Long-term debt	20,142	7,749	5,640	3,601	3,152
Long-term lease Liabilities	15,283	1,411	2,317	1,735	9,820
Accounts payable and accrued liabilities	66,355	66,355	-	-	-
Customer deposits	43,164	43,164	-	-	-
Bank indebtedness and short-term bank loans	45,037	45,037	-	-	-
Derivative liabilities	12	12	-	-	-

On August 31, 2019, the Company's order backlog was \$425.6 million and its net cash plus unused credit facilities amounted to \$94.6 million, which it believes, along with future cash flows generated from operations, is sufficient to meet its financial obligations, increase its capacity, satisfy its working capital requirements, and execute on its business strategy. However, there can be no assurance that the risk of another sharp downturn in the economy will not materially adversely affect the Company's results of operations or financial condition. The Company continues to closely monitor the continued weakness of the price of oil and the euro currency, as well as recent trade protectionist measures and economic sanctions.

As part of managing its liquidity risk, the Company also monitors the financial health of its key customers and suppliers.

Proposed transactions

The Company has not committed to any material asset or business acquisitions or dispositions, other than those already discussed in this MD&A.

Management's Discussion and Analysis

Cash flows - comparison of three and six month periods ended August 31, 2019 and 2018

(unless otherwise noted, all amounts are in U.S. dollars and all comparisons are to same period in the prior fiscal year)

Net cash

(millions)	August 31, 2019	May 31, 2019	February 28, 2019	August 31, 2018	May 31, 2018
Net cash	\$34.9	\$39.4	\$40.9	\$51.3	\$51.6

The Company's net cash decreased by \$4.5 million or 11.4% since the beginning of the current quarter and by \$6.0 million or 14.7% since the beginning of the current fiscal year. The decrease since the beginning of the current fiscal year is primarily attributable to investments in property, plant and equipment, long-term debt and lease liabilities repayments, as well as distributions to shareholders via dividends, partially offset by cash provided by operating activities and an increase in long-term debt. The decrease for the quarter is primarily attributable to investments in property, plant and equipment, long-term debt and lease liabilities repayments, as well as distributions to shareholders via dividends, partially offset by an increase in long-term debt. Net cash was also negatively impacted by the weakening of the euro spot rate against the U.S. dollar over the course of the quarter and half year period.

Cash provided (used) by operating activities

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Net cash provided (used) by operating activities	\$1.2	\$3.1	\$3.0	\$(3.2)

Cash provided by operating activities amounted to \$3.0 million for the current half year period compared to cash used by operating activities of \$3.2 million in the prior year. The current half year's source of funds consisted of positive cash net earnings¹ of \$2.4 million and positive non-cash working capital movements of \$0.6 million. This non-cash working capital increase resulted from the decrease in accounts receivable and an increase in customer deposits, partially offset by an increase in inventories and accounts payable and accrued liabilities. Cash provided by operating activities amounted to \$1.2 million for the current quarter compared to \$3.1 million in the prior year. The current quarter's source of funds consisted of positive cash net earnings¹ of \$5.5 million and negative non-cash working capital movements of \$4.3 million. This non-cash working capital decrease resulted from the increase in inventories and a decrease in accounts payable and accrued liabilities, partially offset by a decrease in accounts receivable, income taxes recoverable and an increase in customer deposits.

Accounts receivable

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Accounts receivable decrease	\$2.6	\$2.3	\$17.2	\$6.9

Accounts receivable balances are a function of the timing of sales and cash collections. The accounts receivable balance decreased in both the current quarter and half year periods due primarily to collections of sales made in prior quarters.

Inventories

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Inventory decrease (increase)	\$(5.1)	\$4.7	\$(11.0)	\$3.1
Customer deposits increase (decrease)	\$3.9	\$(2.8)	\$2.8	\$(5.7)

¹ Net earnings or loss refers to net income or loss attributable to Subordinate and Multiple Voting Shares.

Management's Discussion and Analysis

The inventory increase in the quarter is due to the replenishment of stock following large shipments that occurred in prior quarters as well as the build up of inventory in reaction to the booking of certain large project orders. In order to help finance its investment in inventories, the Company, where possible, obtains customer deposits for large orders. Customer deposits increased for the current quarter and half year due to the timing of the booking of certain large project orders, particularly in the Company's French and North American operations.

Accounts payable and accrued liabilities

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Accounts payable and accrued liabilities decrease	\$10.5	\$1.3	\$9.0	\$1.5

The decrease in accounts payable and accrued liabilities in the current quarter and half year period was primarily related to the timing of payments.

Additions to property, plant and equipment

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Additions to property, plant and equipment	\$1.0	\$3.3	\$1.7	\$5.3

The fluctuations in additions to property, plant and equipment for any period when compared to the prior year comparable period is due to the timing of the receipts of certain equipment.

Dividends paid and repurchase of shares

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Dividends paid	\$0.5	\$0.5	\$1.0	\$2.1

The Company changed its dividend policy two fiscal years ago, reducing the dividend from CA\$0.10 per share per quarter to CA\$0.03 per share per quarter. The new policy took effect, starting with the dividend payment of June 29, 2018. The dividend paid in the first quarter of the prior fiscal year was under the prior dividend policy.

The Board of the Company has authorized on October 10, 2019 a normal course issuer bid to purchase for cancellation up to 151,384 Subordinate Voting Shares representing approximately 2.5 % of the outstanding Subordinate Voting Shares of the Company. The normal course issuer bid is subject to the approval of the Toronto Stock Exchange.

Long-term debt

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Additions of long-term debt	\$1.1	\$-	\$1.1	\$0.6
Repayment of long-term debt	\$1.1	\$1.3	\$1.9	\$1.9

During the current quarter and half year period, while the Company continued to pay down its outstanding long-term debt, one of its French subsidiaries undertook a new debt issuance to finance its operating activities. Specifically, the Company

Management's Discussion and Analysis

borrowed \$1.1 million (€1.0 million) in form of an unsecured bank loan, bearing interest at 0.30% and repayable in 60 monthly installments, expiring in 2024.

Long-term lease liabilities

(millions)	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Repayment of long-term lease liabilities	\$0.3	\$-	\$0.7	\$-

The Company has adopted IFRS 16 at the beginning of the current fiscal year using the modified retrospective transition method whereby the comparative was not restated. As per the new standard, repayments of the capital portion of lease liabilities are considered financing activities in the statement of cash flow.

FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

The Company's activities expose it to a variety of financial risks: market risk (including currency risk, cash flow interest rate risk and fair value interest rate risk), credit risk and liquidity risk. The Company's overall financial risk management program focuses on mitigating unpredictable financial market risks and their potential adverse effects on the Company's financial performance.

The Company's financial risk management is generally carried out by the corporate finance team, based on policies approved by the Board of Directors. The identification, evaluation and hedging of the financial risks are the responsibility of the corporate finance team in conjunction with the finance teams of the Company's subsidiaries. The Company uses derivative financial instruments to hedge certain risk exposures. Use of derivative financial instruments is subject to a policy which requires that no derivative transaction be entered into for the purpose of establishing a speculative or leveraged position (the corollary being that all derivative transactions are to be entered into for risk management purposes only).

Risk overview

The Company's financial instruments and the nature of risks which they may be subject to are set out in the following table:

Financial instrument	Risks			
	Market		Credit	Liquidity
	Currency	Interest rate		
Cash and cash equivalents	X	X	X	
Short-term investments	X	X	X	
Accounts receivable	X		X	
Derivative assets	X		X	
Bank indebtedness	X	X		X
Short-term bank loans	X	X		X
Accounts payable and accrued liabilities	X			X
Customer deposits	X			X
Dividend payable	X			X
Derivative liabilities	X			X
Long-term debt	X	X		X
Long-term lease liabilities	X	X		X

Management's Discussion and Analysis

Market risk

Currency risk

Currency risk on financial instruments is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The Company operates internationally and is exposed to foreign exchange risk arising from various currency exposures. Currency risk arises when future commercial transactions and recognized assets and liabilities are denominated in a currency other than a company's functional currency. The Company has operations with different functional currencies, each of which will be exposed to currency risk based on its specific functional currency.

When possible, the Company matches cash receipts in a foreign currency with cash disbursements in that same currency. The remaining anticipated net exposure to foreign currencies is hedged. To hedge this exposure, the Company uses foreign currency derivatives, primarily foreign exchange forward contracts. These derivatives are not designated as hedges for accounting purposes.

The amounts outstanding as at August 31, 2019 and February 28, 2019 are as follows:

	Range of exchange rates		Gain (loss)		Notional amount	
	August 31, 2019	February 28, 2019	August 31, 2019	February 28, 2019	August 31, 2019	February 28, 2019
			(In thousands of U.S. dollars)	(In thousands of U.S. dollars)	(In thousands of indicated currency)	(In thousands of indicated currency)
			\$	\$		
Foreign exchange forward contracts						
Sell US\$ for CA\$ – 0 to 12 months	1.35-1.36	1.36	(11)	(61)	US\$40,500	US\$26,000
Buy US\$ for CA\$ – 0 to 12 months	1.28-1.30	1.30	1	183	US\$40,500	US\$26,000
Sell US\$ for € – 0 to 12 months	-	1.15-1.18	-	(15)	-	US\$2,010
Sell € for US\$ – 0 to 12 months	1.15	1.14	(1)	(2)	€3,740	€907
Buy € for US\$ – 0 to 12 months	1.10	-	7	-	€3,740	-

Foreign exchange forward contracts are contracts whereby the Company has the obligation to sell or buy the currencies at the strike price. The fair value of the foreign currency instruments is recorded in the consolidated statement of income and reflects the estimated amounts the Company would have paid or received to settle these contracts as at the financial position date. Unrealized gains are recorded as derivative assets and unrealized losses as derivative liabilities on the consolidated statement of financial position.

Cash flow and fair value interest rate risk

The Company's exposure to interest rate risk is related primarily to its credit facilities, long-term debt and cash and cash equivalents. Items at variable rates expose the Company to cash flow interest rate risk, and items at fixed rates expose the Company to fair value interest rate risk. The Company's long-term debt and credit facilities predominantly bear interest, and its cash and cash equivalents earn interest at variable rates. An assumed 0.5% change in interest rates would have no significant impact on the Company's net income or cash flows.

Credit risk

Credit risk is the risk of an unexpected loss if a customer or counterparty to a financial instrument fails to meet its contractual obligations. Credit risk arises primarily from the Company's trade accounts receivable.

The Company's credit risk related to its trade accounts receivable is concentrated. As at August 31, 2019, three (February 28, 2019 – four) customers accounted for more than 5% each of its trade accounts receivable, of which one customer accounted for 14.7% (February 28, 2019 – 10.5%), and the Company's ten largest customers accounted for 53.7% (February 28, 2019 – 58.9%) of trade receivables. In addition, there was one (February 28, 2019 – one) customer that accounted for more than 10% each of the Company's sales.

Management's Discussion and Analysis

In order to mitigate its credit risk, the Company performs a continual evaluation of its customers' credit and performs specific evaluation procedures on all its new customers. In performing its evaluation, the Company analyzes the ageing of accounts receivable, historical payment patterns, customer creditworthiness and current economic trends. A specific credit limit is established for each customer and reviewed periodically. An allowance for doubtful accounts is recorded when, based on management's evaluation, the collection of an account receivable is not reasonably certain.

The Company applies the IFRS 9 simplified approach to measure expected credit losses using a lifetime expected credit loss allowance for trade receivables. The expected credit loss rates are based on the Company's historical credit losses experienced over the last fiscal year prior to period end. The historical rates are then adjusted for current and forward-looking information on macro-economic factors affecting the Company's customers.

For some trade accounts receivable, the Company may obtain security in the form of credit insurance which can be called upon if the counterparty is in default under the terms of the agreement.

The Company is also exposed to credit risk relating to derivative financial instruments, cash and cash equivalents and short-term investments, which it manages by dealing with highly rated financial institutions.

The Company's primary credit risk is limited to the carrying value of the trade accounts receivable and gains on derivative assets.

The table below summarizes the ageing of the trade accounts receivable as at:

(In thousands of U.S. dollars)	August 31, 2019	February 28, 2019
	\$	\$
Current	66,144	75,888
Past due 0 to 30 days	8,033	13,329
Past due 31 to 90 days	9,569	15,860
Past due more than 90 days	27,863	26,845
	<hr/>	<hr/>
	111,609	131,922
Less: Allowance for doubtful accounts	1,957	1,662
	<hr/>	<hr/>
Trade accounts receivable	109,652	130,260
Other receivables	9,779	7,260
	<hr/>	<hr/>
Total accounts receivable	119,431	137,520

The table below summarizes the movement in the allowance for doubtful accounts:

(In thousands of U.S. dollars)	August 31, 2019	August 31, 2018
	\$	\$
Balance – Beginning of the year	1,662	1,088
Bad debt expenses	189	17
Recoveries of trade accounts receivable	-	(32)
Write-off of trade accounts receivable	(28)	(193)
Foreign exchange	134	(50)
	<hr/>	<hr/>
Balance – End of the period	1,957	830

Liquidity risk – see discussion in *liquidity and capital resources* section

Management’s Discussion and Analysis

CONTINGENCIES (in thousands of U.S. dollars, excluding number of cases)

Two of the Company’s U.S. subsidiaries have been named as one of the defendants in a number of pending lawsuits that seek to recover damages for personal injury allegedly caused by exposure to asbestos-containing products manufactured and sold in the past. Management believes it has a strong defence related to certain products that may have contained an internal asbestos containing component. 1,482 claims were outstanding at the end of the reporting period (February 28, 2019 – 1,349). These claims were filed in the states of Arizona, California, Connecticut, District of Columbia, Delaware, Florida, Georgia, Illinois, Indiana, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, New Jersey, New York, North Carolina, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Texas, Virginia, Washington, Wisconsin and West Virginia. During the reporting period, the Company resolved 189 claims (August 31, 2018 – 219) and was the subject of 322 new claims (August 31, 2018 – 280). Because of the many uncertainties inherent in predicting the outcome of these proceedings, as well as the course of asbestos litigation in the United States, management believes that it is not possible to make an estimate of the Company’s asbestos liability. Accordingly, no provision has been set up in the accounts. Settlement costs and legal fees related to these asbestos claims amounted to \$1,315 for the quarter (August 31, 2018 - \$1,434) and \$3,343 (August 31, 2018 - \$3,716) for the half year period.

On December 3, 2014, San Diego Gas & Electric Company (“SDG”) filed a claim against Velan Valve Corp., a wholly-owned subsidiary of the Company, in the Superior Court of the State of California, concerning high pressure valves supplied to SDG and installed at its Palomar Energy Center (“Facility”). This lawsuit alleged damages to the Facility in excess of \$9,000 related to allegedly defective valves supplied by Velan Valve Corp. The claim was for alleged strict product liability and alleged negligence. The Company vigorously defended its position and undertook all actions necessary to protect its reputation. During the six-month period ended August 31, 2019, the Company made a final settlement of this case and recorded a net settlement of \$850.

OFF-BALANCE SHEET ARRANGEMENTS

There have been no material changes from those identified in the annual MD&A.

RELATED PARTY TRANSACTIONS (in thousands of U.S. dollars)

The Company has entered into the following transactions with related parties, which are measured at their exchange value.

- a) PDK Machine Shop Ltd. (“PDK”) is a company owned by certain relatives of the controlling shareholder. PDK is a supplier of machined material components for use in the Company’s plants.

	Three month period ended August 31		Six month period ended August 31	
	2019	2018	2019	2018
Purchases of material components	\$191	\$136	\$408	\$594

The Company entered into an agreement with PDK pursuant to which it has the right to purchase the shares of PDK for a consideration equal to the book value thereof in the event that they propose to sell their shares to a third party. In the event that PDK proposes to sell all or substantially all of its assets to a third party, the Company has the right to purchase inventory at cost and other assets at book value. In the event of a proposed liquidation or sale of sufficient assets such that PDK cannot fulfill its obligations to the Company under any outstanding purchase orders, the Company also has the right and the obligation to purchase PDK’s inventory at an amount equal to the cost thereof. The maximum obligation of the Company pursuant to such put right is \$200.

Management's Discussion and Analysis

CONTROLS AND PROCEDURES

The Company did not make any changes to the design of internal controls over financial reporting during the six-month period ended August 31, 2019 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

CRITICAL ACCOUNTING ESTIMATES & JUDGEMENTS

The Company's financial statements are prepared in accordance with IFRS as issued by the IASB. The Company's significant accounting policies as described in note 2 and 3 of the Company's audited consolidated financial statements are essential to understanding the Company's financial positions, results of operations and cash flows. Certain of these accounting policies require critical accounting estimates that involve complex and subjective judgments and the use of assumptions, some of which may be for matters that are inherently uncertain and susceptible to change. The assumptions and estimates used are based on parameters which are derived from the knowledge at the time of preparing the financial statements and believed to be reasonable under the circumstances. In particular, the circumstances prevailing at this time and assumptions as to the expected future development of the global and industry-specific environment were used to estimate the Company's future business performance. Where these conditions develop differently than assumed and beyond the control of the Company, the actual results may differ from those anticipated (see *Forward-looking information* section above). These estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is changed. There were no significant changes made to critical accounting estimates during the past two fiscal years.

There have been no material changes from those identified in the annual MD&A.

ACCOUNTING STANDARDS AND AMENDMENTS ADOPTED IN THE PERIOD

- (i) In January 2016, the IASB issued IFRS 16, *Leases*, which sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract. It eliminates the classification of leases as either operating leases or finance leases and introduces a single lessee accounting model for lessees. It substantially carries forward the lessor accounting requirements. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently. IFRS 16 replaces IAS 17, *Leases*, IFRIC 4, *Determining whether an Arrangement contains a Lease*, SIC-15, *Operating Leases – Incentives*, and SIC-27, *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

The new standard was adopted effective March 1, 2019 and the Company elected the modified retrospective transition method on the effective date, without restatement of the comparative figures. As such, comparative information continues to be reported under previous accounting standards.

At inception of a contract, the Company assesses whether a contract is, or contains, a lease based on whether the contract includes the right to control the use of an identified asset for a period of time in exchange for consideration.

In situations where the Company is a lessee, the result is the recording, at the lease commencement date, of a right-of-use asset and a lease liability for the present value of the future lease payments on the statement of financial position for most of its contracts that were considered operating leases under IAS 17. In order to determine the present value of the future lease payments, the Company uses the interest rate implicit in the lease or, if that rate cannot be readily determined, the Company uses the incremental borrowing rate of each of its subsidiaries. The Company depreciates its right-of-use asset on the lesser of the lease term or the useful life of the asset using the straight-line method since it closely reflects the expected pattern of consumption of the future economic benefits.

Management's Discussion and Analysis

The right-of-use asset may be periodically reduced by impairment losses, if any, and adjusted for certain remeasurement of the lease liability. The lease liability is measured at amortized cost using the effective interest method. It is remeasured when there is a change in future lease payments arising from a change in an index, rate or estimate. The lease liability is remeasured with a corresponding adjustment to the carrying value of the right-of use asset. If the carrying value of the right-of-use asset has been reduced to zero, the remaining adjustment is recorded in the statement of income (loss).

Cash payments for the principal portion of the lease liability are presented within the financial activities and the interest portion of the lease liability is presented within the operating activities of the statement of cash flows. Payments associated with short-term leases and leases of low-value assets are not included in the measurement of the lease liability and are presented in operating activities in the statement of cash flows.

At the date of initial application, the Company elected to measure the right-of-use asset in an amount equal to the lease liability. The Company also applied the following practical expedients when applying IFRS 16 to leases previously classified as operating leases under IAS 17:

- a) The Company elected to apply the standard to contracts that were previously identified as leases under IAS 17 and IFRIC 4 and elected to not apply the standard to contracts that were not previously identified as leases under IAS 17 and IFRIC 4.
- b) The Company has elected to exclude intangible assets from the scope of this standard.
- c) The Company used the exemptions proposed by the standard on lease contracts for which the lease terms end within 12 months as the date of initial application, and lease contracts for which the underlying asset is of low value.
- d) The Company used hindsight to determine the lease terms if the contract contained options to extend or terminate the lease term.

The following table reconciles the Company's operating lease obligations at February 28, 2019 to the lease liabilities recognized on initial application of IFRS 16 at March 1, 2019.

Operating Lease Commitments disclosed as at February 28, 2019	15,763
Discounted using the lessee's weighted average incremental borrowing rate of 2.49% at the date of initial application	(4,249)
Less: Short-term leases and low-value leases recognized on a straight-line basis as an expense	(331)
Add/(less): Adjustments as a result of a different treatment of extension and termination options	3,980
Lease liability recognized as at March 1, 2019	15,163
Of which are:	
Current portion of long-term lease liabilities	1,290
Long-term lease liabilities	13,873

Management's Discussion and Analysis

The recognized right-of-use assets relate to the following types of assets:

	As at August 31, 2019 \$	As at March 1, 2019 \$
Land	6,258	6,528
Buildings	7,138	7,150
Furniture & Fixtures	40	48
Data Processing Equipment	189	241
Rolling Stock	1,550	1,196
Total Right of use asset	15,175	15,163

The following table summarizes the impact of adopting IFRS 16 on the Company's consolidated statement of financial position as at March 1, 2019. Prior amounts have not been restated. The Company's transition to IFRS 16 did not impact the Company's retained earnings.

	February 28, 2019 \$	Adjustment due to IFRS 16 \$	March 1, 2019 \$
Non-current assets			
Property, Plant and Equipment	83,537	15,163	98,700
Current liabilities			
Current portion of long-term lease liabilities	-	1,290	1,290
Non-current liabilities			
Long-term lease liabilities	-	13,873	13,873

- (ii) In June 2017, IFRIC issued IFRIC 23, *Uncertainty over Income Tax Treatments*. This interpretation clarifies how the recognition and measurement requirements of IAS 12, *Income Taxes*, are applied where there is uncertainty over income tax treatments that have yet to be accepted by tax authorities.

The Company has adopted the interpretation of IFRIC 23 on March 1, 2019 and concluded that it has no impact on previously reported results.

CERTAIN RISKS THAT COULD AFFECT OUR BUSINESS

There have been no material changes from those identified in the annual MD&A.

Management's Discussion and Analysis

SUMMARY OF RESULTS

Summary financial data derived from the Company's financial statements prepared in accordance with IFRS for the three most recently completed reporting periods are as follows:

For the reporting periods ended on the following dates
(in thousands of U.S. dollars, excluding number of shares and per share amounts)

	Fiscal year ended February 28, 2019	Fiscal year ended February 28, 2018	Fiscal year ended February 28, 2017
Operating Data			
Sales	\$366,865	\$337,963	\$331,777
Net Earnings (loss) ¹	(4,882)	(17,811)	7,737
Earnings (loss) per Share			
- Basic	(0.23)	(0.82)	0.36
- Diluted	(0.23)	(0.82)	0.36
Balance Sheet Data			
Total Assets	524,357	540,193	519,297
Total Long-Term Financial Liabilities	21,723	22,200	22,532
Shareholder Data			
Cash dividends per share			
- Multiple Voting Shares ²	0.09	0.31	0.31
- Subordinate Voting Shares	0.09	0.31	0.31
Outstanding Shares at report date			
- Multiple Voting Shares ²	15,566,567		
- Subordinate Voting Shares	6,055,368		

Sales for fiscal year 2019 increased by 8.6% compared to fiscal year 2018. This increase was primarily attributable to an increase in shipments from the Company's North American, Korean and Indian subsidiaries, which were partially offset by decreased shipments from the Company's German operations. The Company was able to notably improve its MRO business as well as increasing its shipments related to large project orders. Sales for fiscal year 2018 increased by 1.9% compared to fiscal year 2017. This increase was primarily attributable to an increase in shipments from the Company's Italian subsidiary, which were offset by decreased shipments from the Company's North American operations. Delays in shipments of certain large project orders caused by various customer-related, supply chain and internal operational issues, and lower shipments of non-project commodity valves negatively impacted the Company's North American operations in fiscal year 2018.

Gross profit for fiscal year 2019 amounted to \$85.6 million, an increase of \$14.7 million from fiscal year 2018, while the gross profit percentage increased from the 21.0% reported in fiscal year 2018 to 23.3% in fiscal year 2019. This increase was due primarily to the higher sales volume achieved by the Company's North American, Korea and Indian operations combined with the shipment of a more efficient product mix by the Company's French operations, which was partially offset by the lower sales volume shipped by the Company's German operations. Gross profit for fiscal year 2018 amounted to \$70.9 million, a decrease of \$17.6 million from fiscal year 2017, while the gross profit percentage decreased from the 26.7% reported in fiscal year 2017 to 21.0% in fiscal year 2018. This decrease was due primarily to the Company's North American operations, which shipped a product mix with a greater proportion of projects with lower margins, coupled with pricing pressures brought on by fierce competition and continued weakness in certain markets, which was only partially offset by material cost savings.

Administration costs for fiscal year 2019 increased by \$5.6 million when compared to fiscal year 2018. This fluctuation was attributable to an increase in bad debt expense, selling expenses, retirement expenses and freight charges for certain overseas project customers resulting from the higher sales volume as well as the need to incur air freight costs on a large delayed order. The Company had also invested \$1.0 million in its current transformation initiative, Velocity 2020. The Company also experienced an increase in costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section). Administration costs for fiscal year 2018 increased by \$11.8 million when compared to fiscal year 2017. This increase was primarily attributable to an increase in sales commissions and freight charges due to the increased sales volume, an increase in technology license fees paid on the sale of certain highly-engineered cryogenic valves, and an increase in costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section).

The fiscal year 2018 net loss¹ was also negatively impacted by a \$4.3 million one-time income tax charge due to the U.S. tax reform legislation passed in December 2017.

¹ Net earnings or loss refers to net income or loss attributable to Subordinate and Multiple Voting Shares.

² Multiple Voting Shares (five votes per share) are convertible into Subordinate Voting Shares on a 1 to 1 basis.

Management's Discussion and Analysis

RECONCILIATIONS OF NON-IFRS MEASURES

In this MD&A, the Company presented measures of performance or financial condition which are not defined under IFRS ("non-IFRS measures") and are therefore unlikely to be comparable to similar measures presented by other companies. These measures are used by management in assessing the operating results and financial condition of the Company and are reconciled with the performance measures defined under IFRS. Reconciliations of these amounts can be found below.

Net income (loss) before interest, taxes, depreciation and amortization ("EBITDA")

	Three-month period ended August 31, 2019	Three-month period ended August 31, 2018	Six-month period ended August 31, 2019	Six-month period ended August 31, 2018
Net income (loss) attributable to Subordinate Voting Shares and Multiple Voting Shares	1.4	(2.4)	(4.5)	(6.2)
Ajustements for:				
Depreciation of property, plant and equipment	2.6	2.9	5.2	5.5
Amortization of intangible assets	0.5	0.4	1.0	0.9
Finance costs (income) – net	(0.2)	0.6	0.1	0.6
Income taxes	0.9	(0.1)	(0.9)	(0.9)
EBITDA	5.2	(1.4)	0.9	(0.1)

Velan Inc.

Unaudited Condensed Interim Consolidated Financial Statements For the three-month and six-month periods ended August 31, 2019

Notice of No Auditor Review of Interim Consolidated Financial Statements

In accordance with National Instrument 51-102 released by the Canadian Securities Administrators, the Company discloses that its auditors PricewaterhouseCoopers LLP have not reviewed the unaudited condensed interim consolidated financial statements for the three-month and six-month periods ended August 31, 2019

Velan Inc.

Condensed Interim Consolidated Statements of Financial Position

(Unaudited)

(in thousands of U.S. dollars)

As At	August 31, 2019 \$	February 28, 2019 \$
Assets		
Current assets		
Cash and cash equivalents	78,267	70,673
Short-term investments	2,296	658
Accounts receivable	119,431	137,520
Income taxes recoverable	15,042	16,863
Inventories (note 7)	176,035	165,583
Deposits and prepaid expenses	4,065	4,612
Derivative assets	8	189
	395,144	396,098
Non-current assets		
Property, plant and equipment (note 3)	95,981	83,537
Intangible assets and goodwill	16,760	18,146
Deferred income taxes	24,658	25,947
Other assets	509	629
	137,908	128,259
Total assets	533,052	524,357
Liabilities		
Current liabilities		
Bank indebtedness	43,357	29,807
Short-term bank loans	1,680	2,172
Accounts payable and accrued liabilities	66,355	74,910
Income taxes payable	1,235	495
Dividend payable	501	497
Customer deposits	43,164	40,240
Provisions	7,465	8,494
Accrual for performance guarantees	21,669	23,014
Derivative liabilities	12	83
Current portion of long-term debt	7,749	8,609
Current portion of long-term lease liabilities (note 3)	1,411	-
	194,598	188,321
Non-current liabilities		
Long-term debt	12,393	13,242
Long-term lease liabilities (note 3)	13,872	-
Income taxes payable	1,742	1,742
Deferred income taxes	3,411	3,738
Other liabilities	8,239	8,481
	39,657	27,203
Total liabilities	234,255	215,524
Equity		
Equity attributable to the Subordinate and Multiple Voting shareholders		
Share capital (note 8)	73,090	73,090
Contributed surplus	6,076	6,074
Retained earnings	249,185	254,606
Accumulated other comprehensive loss	(33,388)	(28,990)
	294,963	304,780
Non-controlling interest	3,834	4,053
Total equity	298,797	308,833
Total liabilities and equity	533,052	524,357
Commitments and contingencies (note 9)		

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

Velan Inc.

Condensed Interim Consolidated Statements of Income (Loss)

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

	Three-month periods ended August 31		Six-month periods ended August 31	
	2019 \$	2018 \$	2019 \$	2018 \$
Sales	85,467	91,375	169,283	169,249
Cost of sales (note 7)	63,485	72,032	131,207	132,169
Gross profit	21,982	19,343	38,076	37,080
Administration costs	19,995	21,460	43,458	43,684
Other expense (income)	4	(8)	(53)	(24)
Operating profit (loss)	1,983	(2,109)	(5,329)	(6,580)
Finance income	595	220	735	362
Finance costs	409	770	876	944
Finance income (costs) – net	186	(550)	(141)	(582)
Income (Loss) before income taxes	2,169	(2,659)	(5,470)	(7,162)
Provision for (Recovery of) income taxes	851	(104)	(968)	(933)
Net income (loss) for the period	1,318	(2,555)	(4,502)	(6,229)
Net income (loss) attributable to:				
Subordinate Voting Shares and Multiple Voting Shares	1,369	(2,438)	(4,455)	(6,165)
Non-controlling interest	(51)	(117)	(47)	(64)
	1,318	(2,555)	(4,502)	(6,229)
Net income (loss) per Subordinate and Multiple Voting Share				
Basic	0.06	(0.11)	(0.21)	(0.28)
Diluted	0.06	(0.11)	(0.21)	(0.28)
Dividends declared per Subordinate and Multiple Voting Share	0.02 (CA\$0.03)	0.02 (CA\$0.03)	0.04 (CA\$0.06)	0.05 (CA\$0.06)
Total weighted average number of Subordinate and Multiple Voting Shares				
Basic	21,621,935	21,621,935	21,621,935	21,621,935
Diluted	21,621,935	21,621,935	21,621,935	21,621,935

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

Velan Inc.

Condensed Interim Consolidated Statements of Comprehensive Income (Loss)

(Unaudited)

(in thousands of U.S. dollars)

	Three-month periods ended August 31		Six-month periods ended August 31	
	2019 \$	2018 \$	2019 \$	2018 \$
Comprehensive loss				
Net income (loss) for the period	1,318	(2,555)	(4,502)	(6,229)
Other comprehensive loss				
Foreign currency translation adjustment on foreign operations whose functional currency is other than the reporting currency (U.S. dollar)	(1,719)	(1,390)	(4,570)	(6,822)
Comprehensive loss	(401)	(3,945)	(9,072)	(13,051)
Comprehensive loss attributable to:				
Subordinate Voting Shares and Multiple Voting Shares	(316)	(3,732)	(8,853)	(12,900)
Non-controlling interest	(85)	(213)	(219)	(151)
	(401)	(3,945)	(9,072)	(13,051)

Other comprehensive loss is composed solely of items that may be reclassified subsequently to the consolidated statement of income (loss).

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

Velan Inc.

Condensed Interim Consolidated Statements of Changes in Equity

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares)

	Equity attributable to the Subordinate and Multiple Voting shareholders							Total equity
	Number of shares	Share capital	Contributed surplus	Accumulated other comprehensive loss	Retained earnings	Total	Non-controlling interest	
Balance - February 28, 2019	21,621,935	73,090	6,074	(28,990)	254,606	304,780	4,053	308,833
Net loss for the period	-	-	-	-	(4,455)	(4,455)	(47)	(4,502)
Other comprehensive loss	-	-	-	(4,398)	-	(4,398)	(172)	(4,570)
	21,621,935	73,090	6,074	(33,388)	250,151	295,927	3,834	299,761
Effect of share-based compensation (note 8 (c))	-	-	2	-	-	2	-	2
Dividends								
Multiple Voting Shares	-	-	-	-	(696)	(696)	-	(696)
Subordinate Voting Shares	-	-	-	-	(270)	(270)	-	(270)
Balance - August 31, 2019	21,621,935	73,090	6,076	(33,388)	249,185	294,963	3,834	298,797
Balance - February 28, 2018	21,621,935	73,090	6,057	(19,790)	256,668	316,025	5,592	321,617
Adjustment related to the transition to IFRS 15	-	-	-	-	4,741	4,741	-	4,741
Adjusted balance - March 1, 2018	21,621,935	73,090	6,057	(19,790)	261,409	320,766	5,592	326,358
Net loss for the period	-	-	-	-	(6,165)	(6,165)	(64)	(6,229)
Other comprehensive income	-	-	-	(6,735)	-	(6,735)	(87)	(6,822)
	21,621,935	73,090	6,057	(26,525)	255,244	307,866	5,441	313,307
Effect of share-based compensation (note 8 (c))	-	-	9	-	-	9	-	9
Dividends								
Multiple Voting Shares	-	-	-	-	(685)	(685)	-	(685)
Subordinate Voting Shares	-	-	-	-	(264)	(264)	-	(264)
Non-controlling interest	-	-	-	-	-	-	(927)	(927)
Balance - August 31, 2018	21,621,935	73,090	6,066	(26,525)	254,295	306,926	4,514	311,440

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

Velan Inc.

Condensed Interim Consolidated Statements of Cash Flow

(Unaudited)

(in thousands of U.S. dollars)

	Three-month periods ended August 31		Six-month periods ended August 31	
	2019 \$	2018 \$	2019 \$	2018 \$
Cash flows from				
Operating activities				
Net income (loss) for the period	1,318	(2,555)	(4,502)	(6,229)
Adjustments to reconcile net income (loss) to cash provided (used) by operating activities (note 10)	4,230	3,453	6,913	7,003
Changes in non-cash working capital items (note 11)	(4,315)	2,225	544	(3,980)
Cash provided (used) by operating activities	1,233	3,123	2,955	(3,206)
Investing activities				
Short-term investments	(1,634)	438	(1,638)	489
Additions to property, plant and equipment	(966)	(3,278)	(1,714)	(5,290)
Additions to intangible assets	(111)	(3)	(133)	(99)
Proceeds on disposal of property, plant and equipment, and intangible assets	7	115	39	125
Net change in other assets	(1,341)	51	(1,328)	578
Cash used by investing activities	(4,045)	(2,677)	(4,774)	(4,197)
Financing activities				
Dividends paid to Subordinate and Multiple Voting shareholders	(486)	(488)	(962)	(2,130)
Dividends paid to non-controlling interest	-	-	-	(927)
Short-term bank loans	(53)	1,020	(492)	985
Increase in long-term debt	1,122	-	1,122	607
Repayment of long-term debt	(1,143)	(1,268)	(1,859)	(1,930)
Repayment of long-term lease liabilities (note 3)	(262)	-	(658)	-
Cash used by financing activities	(822)	(736)	(2,849)	(3,395)
Effect of exchange rate differences on cash	(853)	(3)	(1,288)	(2,411)
Net change in cash during the period	(4,487)	(293)	(5,956)	(13,209)
Net cash – Beginning of the period	39,397	51,627	40,866	64,543
Net cash – End of the period	34,910	51,334	34,910	51,334
Net cash is composed of:				
Cash and cash equivalents	78,267	70,114	78,267	70,114
Bank indebtedness	(43,357)	(18,780)	(43,357)	(18,780)
	34,910	51,334	34,910	51,334
Supplementary information				
Interest paid	179	132	458	168
Income taxes paid	1,676	2,421	3,507	4,354

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

For the three-month and six-month periods ended August 31, 2019

1 General information

These unaudited condensed interim financial statements represent the consolidation of the accounts of Velan Inc. (the “Company”) and its subsidiaries. The Company is an international manufacturer of industrial valves and is a public company listed on the Toronto Stock Exchange under the symbol “VLN”. It was incorporated under the name Velan Engineering Ltd. on December 12, 1952 and continued under the *Canada Business Corporations Act* on February 11, 1977. It changed its name to Velan Inc. on February 20, 1981. Velan Inc. maintains its registered head office at 7007 Cote de Liesse, Montreal, Quebec, Canada, H4T 1G2. The Company’s ultimate parent company is Velan Holdings Co. Ltd.

These unaudited condensed interim consolidated financial statements were approved for issue by the Company’s Board of Directors on October 10, 2019. The Company’s auditors have not performed a review of these unaudited condensed interim consolidated financial statements.

2 Basis of preparation

These unaudited condensed interim consolidated financial statements for the three-month and six-month periods ended August 31, 2019 have been prepared in accordance with International Financial Reporting Standards (“IFRS”) in accordance with International Accounting Standard (“IAS”) 34, *Interim Financial Reporting*. Except as disclosed in Note 3 below, these unaudited condensed interim consolidated financial statements have been prepared using the same basis of presentation, accounting policies, and methods of computation as outlined in Note 2, *Summary of significant accounting policies*, in the Company’s annual consolidated financial statements for the year ended February 28, 2019, which have also been prepared in accordance with IFRS. Accordingly, these unaudited condensed interim consolidated financial statements should be read in conjunction with the Company’s annual consolidated financial statements for the year ended February 28, 2019.

3 Changes in accounting policies

- (i) In January 2016, the IASB issued IFRS 16, *Leases*, which sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract. It eliminates the classification of leases as either operating leases or finance leases and introduces a single lessee accounting model for lessees. It substantially carries forward the lessor accounting requirements. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently. IFRS 16 replaces IAS 17, *Leases*, IFRIC 4, *Determining whether an Arrangement contains a Lease*, SIC-15, *Operating Leases – Incentives*, and SIC-27, *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

The new standard was adopted effective March 1, 2019 and the Company elected the modified retrospective transition method on the effective date, without restatement of the comparative figures. As such, comparative information continues to be reported under previous accounting standards.

At inception of a contract, the Company assesses whether a contract is, or contains, a lease based on whether the contract includes the right to control the use of an identified asset for a period of time in exchange for consideration.

In situations where the Company is a lessee, the result is the recording, at the lease commencement date, of a right-of-use asset and a lease liability for the present value of the future lease payments on the statement of financial position for most of its contracts that were considered operating leases under IAS 17. In order to

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

determine the present value of the future lease payments, the Company uses the interest rate implicit in the lease or, if that rate cannot be readily determined, the Company uses the incremental borrowing rate of each of its subsidiaries. The Company depreciates its right-of-use asset on the lesser of the lease term or the useful life of the asset using the straight-line method since it closely reflects the expected pattern of consumption of the future economic benefits.

The right-of-use asset may be periodically reduced by impairment losses, if any, and adjusted for certain remeasurement of the lease liability. The lease liability is measured at amortized cost using the effective interest method. It is remeasured when there is a change in future lease payments arising from a change in an index, rate or estimate. The lease liability is remeasured with a corresponding adjustment to the carrying value of the right-of-use asset. If the carrying value of the right-of-use asset has been reduced to zero, the remaining adjustment is recorded in the statement of income (loss).

Cash payments for the principal portion of the lease liability are presented within the financial activities and the interest portion of the lease liability is presented within the operating activities of the statement of cash flows. Payments associated with short-term leases and leases of low value assets are not included in the measurement of the lease liability and are presented in operating activities in the statement of cash flows.

At the date of initial application, the Company elected to measure the right-of-use asset in an amount equal to the lease liability. The Company also applied the following practical expedients when applying IFRS 16 to leases previously classified as operating leases under IAS 17:

- a) The Company elected to apply the standard to contracts that were previously identified as leases under IAS 17 and IFRIC 4 and elected to not apply the standard to contracts that were not previously identified as leases under IAS 17 and IFRIC 4.
- b) The Company has elected to exclude intangible assets from the scope of this standard.
- c) The Company used the exemptions proposed by the standard on lease contracts for which the lease terms end within 12 months as the date of initial application, and lease contracts for which the underlying asset is of low value.
- d) The Company used hindsight to determine the lease terms if the contract contained options to extend or terminate the lease term.

The following table reconciles the Company's operating lease obligations at February 28, 2019 to the lease liabilities recognized on initial application of IFRS 16 at March 1, 2019.

Operating Lease Commitments disclosed as at February 28, 2019	15,763
Discounted using the lessee's weighted average incremental borrowing rate of 2.49% at the date of initial application	(4,249)
(Less): Short-term leases and low-value leases recognized on straight-line basis as expense	(331)
Add/(less): Adjustments as a result of a different treatment of extension and termination options	3,980
	<hr/>
Lease liability recognized as at March 1, 2019	15,163
Of which are:	
Current portion of long-term lease liabilities	1,290
Long-term lease liabilities	13,873

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

The recognized right-of-use assets relate to the following types of assets:

	As at August 31, 2019 \$	As at March 1, 2019 \$
Land	6,258	6,528
Buildings	7,138	7,150
Furniture & Fixtures	40	48
Data Processing Equipment	189	241
Rolling Stock	1,550	1,196
Total Right of use asset	15,175	15,163

The following table summarizes the impact of adopting IFRS 16 on the Company's consolidated statement of financial position as at March 1, 2019. Prior amounts have not been restated. The Company's transition to IFRS 16 did not impact the Company's retained earnings.

	February 28, 2019 \$	Adjustment due to IFRS 16 \$	March 1, 2019 \$
Non-current assets			
Property, Plant and Equipment	83,537	15,163	98,700
Current liabilities			
Current portion of long-term lease liabilities	-	1,290	1,290
Non-current liabilities			
Long-term lease liabilities	-	13,873	13,873

- (ii) In June 2017, IFRIC issued IFRIC 23, *Uncertainty over Income Tax Treatments*. This interpretation clarifies how the recognition and measurement requirements of IAS 12, *Income Taxes*, are applied where there is uncertainty over income tax treatments that have yet to be accepted by tax authorities.

The Company has adopted the interpretation of IFRIC 23 on March 1, 2019 and concluded that it has no impact on previously reported results.

4 Estimates

The preparation of interim financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expense. Actual results may differ from these estimates.

In preparing these unaudited condensed interim consolidated financial statements, the significant judgements made by management in applying the Company's accounting policies and the key sources of estimation uncertainty were the same as those that applied to the annual consolidated financial statements for the year ended February 28, 2019.

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

5 Seasonality

The Company's sales are not subject to seasonality. Quarterly sales can vary greatly based on the timing of revenue recognition on large project orders.

6 Operating segment information

Consistent with the prior fiscal year, the Company reflects its results under a single reportable operating segment.

7 Inventories

	August 31, 2019 \$	February 28, 2019 \$
Raw materials	34,691	35,858
Work in process and finished parts	107,234	96,863
Finished goods	34,110	32,862
	<u>176,035</u>	<u>165,583</u>

As a result of variations in the ageing of its inventories, the Company recognized a net additional inventory provision for the six-month period ended August 31, 2019 of \$2,853 (August 31, 2018 – \$984), including reversals of \$2,007 (August 31, 2018 - \$4,814). The Company recognized a net additional inventory provision for the three-month period ended August 31, 2019 of \$1,651 (August 31, 2018 – net inventory provision recovery of \$207), including reversals of \$932 (August 31, 2018 - \$3,592).

8 Capital stock

- a) Authorized – in unlimited number
- Preferred Shares, issuable in series
 - Subordinate Voting Shares
 - Multiple Voting Shares (five votes per share), convertible into Subordinate Voting Shares

- b) Issued

	August 31, 2019 \$	February 28, 2019 \$
6,055,368 Subordinate Voting Shares (notes 8(c))	65,964	65,964
15,566,567 Multiple Voting Shares	7,126	7,126
	<u>73,090</u>	<u>73,090</u>

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

- c) The Company established a fixed share option plan (the “Share Option Plan”) in 1996, amended in fiscal 2007, to allow for the purchase of Subordinate Voting Shares by certain of its full-time employees, directors, officers and consultants.

The subscription price for Subordinate Voting Shares granted under options is the greater of (i) the weighted average trading price for such Subordinate Voting Shares for the five days preceding the date of grant during which the Subordinate Voting Shares were traded on the Toronto Stock Exchange (“TSX”) or (ii) the trading price for the Subordinate Voting Shares on the last day the Subordinate Voting Shares were traded on the TSX immediately preceding the date of grant.

Under the Share Option Plan, the maximum number of Subordinate Voting Shares issuable from time to time is a fixed maximum percentage of 5% of the aggregate of the Multiple Voting Shares and the Subordinate Voting Shares issued and outstanding from time to time.

The granting of options is at the discretion of the Board of Directors which, at the date of grant, establishes the term and vesting period. Vesting of options generally commences 12 months after the date of grant and accrues annually over the vesting period provided there is continuous employment. The maximum term permissible is 10 years.

For the six-month period ended August 31, 2019, a compensation cost of \$2 (August 31, 2018 – \$9) was recorded in the consolidated statement of income (loss) and credited to contributed surplus. For the three-month period ended August 31, 2018, a compensation cost of \$1 (August 31, 2018 – \$5) was recorded in the consolidated statement of income (loss) and credited to contributed surplus.

The table below summarizes the status of the Share Option Plan.

	Number of shares	Weighted average exercise price	Weighted average contractual life in months
Outstanding – February 28, 2019	140,000	\$14.63 (CA\$19.26)	14.4
Outstanding – August 31, 2019	140,000	\$14.49 (CA\$19.26)	8.4
Exercisable – August 31, 2019	130,000	\$14.72 (CA\$19.57)	

- d) On July 13, 2017, the Company adopted a performance share unit (“PSU”) plan allowing the Board of Directors, through its Corporate Governance and Human Resources (“CGHR”) Committee, to grant PSUs to certain of its full-time employees. A PSU is a notional unit whose value is based on the volume weighted average price of the Company’s Subordinate Voting Shares on the Toronto Stock Exchange for the 20 trading days immediately preceding the grant date. The PSU plan is non-dilutive since vested PSUs shall be settled solely in cash. Each PSU grant shall vest at the end of a three-year performance cycle, which will normally start on March 1 of the year in which such PSU is granted and end on the last day of February of the third year following such grant, subject to the achievement of certain performance objectives over such cycle, as determined by the Company’s CGHR Committee.

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

As at August 31, 2019, the Company had a total of 24,711 (February 28, 2019 – 24,611) PSUs outstanding, representing a total liability of \$35 (February 28, 2019 – \$71) which is included in accounts payable and accrued liabilities. For the six-month period ended August 31, 2019, a compensation cost recovery of \$36 (August 31, 2018 – \$17) was recorded in the consolidated statement of income (loss) and decreased accounts payable and accrued liabilities. For the three-month period ended August 31, 2019, a compensation cost recovery of \$8 (August 31, 2018 – \$31) was recorded in the consolidated statement of income (loss) and decreased accounts payable and accrued liabilities. No payments have been made in relation to PSUs since the inception of the plan. No PSUs were forfeited, and no PSUs have vested during the three-month and the six-month periods ended August 31, 2019 and August 31, 2018.

- e) On July 13, 2017, the Company adopted a deferred share unit (“DSU”) plan allowing the Board of Directors, through its CGHR Committee, to grant DSUs to certain of its independent directors and full-time employees. A DSU is a notional unit whose value is based on the volume weighted average price of the Company’s Subordinate Voting Shares on the Toronto Stock Exchange for the 20 trading days immediately preceding the grant date. The DSU plan is non-dilutive since vested DSUs shall be settled solely in cash. Each DSU grant shall vest at the earlier of:
- the sixth anniversary of its grant date; or
 - the day the holder of the DSU attains the retirement age, which, unless otherwise determined by the CGHR Committee, is the earliest of age 65, or the age at which the combination of years of service at the Company plus his or her age is equal to 75, being understood that the retirement age shall not be less than 55 years old.

For more certainty, a grant made to an independent director or full-time employee who has reached the retirement age will vest immediately, unless otherwise determined by the CGHR Committee at or after the time of grant. Notwithstanding the foregoing, grants of DSUs made to non-employee directors of the Company vest on their grant date.

As at August 31, 2019, the Company had a total of 51,678 (February 28, 2019 – 28,768) DSUs outstanding, representing a total liability of \$119 (February 28, 2019 – \$98) which is included in accounts payable and accrued liabilities. For the six-month period ended August 31, 2019, a compensation cost of \$21 (August 31, 2018 – \$49) was recorded in the consolidated statement of income (loss) and increased accounts payable and accrued liabilities. For the three-month period ended August 31, 2019, a compensation cost of \$13 (August 31, 2018 – \$58) was recorded in the consolidated statement of income (loss) and increased accounts payable and accrued liabilities. No payments have been made in relation to DSUs and no DSUs were forfeited during the three-month and six-month periods ended August 31, 2019 and August 31, 2018 and 18,353 (February 28, 2019 – 11,178) DSUs have vested as at August 31, 2019.

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

9 Contingent liabilities

Two of the Company's U.S. subsidiaries have been named as defendants in a number of asbestos-related legal proceedings pertaining to products they formerly sold. Management believes it has a strong defence, and the subsidiaries have previously been dismissed from a number of similar cases. Because of the many uncertainties inherent in predicting the outcome of these proceedings, as well as the course of asbestos litigation in the United States, management believes that it is not possible to make an estimate of the subsidiaries' asbestos liability. Accordingly, no provision has been set up in the accounts.

During the six-month period ended August 31, 2019, legal and related costs for these matters amounted to \$3,343 (August 31, 2018 – \$3,716). During the three-month period ended August 31, 2019, legal and related costs for these matters amounted to \$1,315 (August 31, 2018 – \$1,434).

Lawsuits and proceedings or claims arising from the normal course of operations are pending or threatened against the Company.

On December 3, 2014, San Diego Gas & Electric Company ("SDG") filed a claim against Velan Valve Corp., a wholly-owned subsidiary of the Company, in the Superior Court of the State of California, concerning high pressure valves supplied to SDG and installed at its Palomar Energy Center ("Facility").

This lawsuit alleged damages to the Facility in excess of \$9,000 related to allegedly defective valves supplied by Velan Valve Corp. The claim was for alleged strict product liability and alleged negligence. During the six-month period ended August 31, 2019, the Company has recorded a final net settlement of \$850 in regard to the claim.

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

10 Adjustments to reconcile net income (loss) to cash provided (used) from operating activities

	Three-month periods ended August 31,		Six-month periods ended August 31,	
	2019 \$	2018 \$	2019 \$	2018 \$
Depreciation of property, plant and equipment	2,607	2,922	5,174	5,499
Amortization of intangible assets	543	441	995	899
Deferred income taxes	707	(109)	858	(86)
Share-based compensation expense (note 8 (c))	1	5	2	9
Loss on disposal of property, plant and equipment	14	29	33	19
Net change in derivative assets and liabilities	(220)	(49)	105	368
Net change in other liabilities	578	214	(254)	295
	<u>4,230</u>	<u>3,453</u>	<u>6,913</u>	<u>7,003</u>

11 Changes in non-cash working capital items

	Three-month periods ended August 31,		Six-month periods ended August 31,	
	2019 \$	2018 \$	2019 \$	2018 \$
Accounts receivable	2,552	2,296	17,216	6,940
Inventories	(5,050)	4,664	(10,956)	3,116
Income taxes recoverable	5,720	(2,255)	1,733	(4,190)
Deposits and prepaid expenses	(444)	617	521	251
Accounts payable and accrued liabilities	(10,468)	(1,281)	(8,968)	(1,533)
Income taxes payable	438	296	704	(875)
Customer deposits	3,890	(2,824)	2,783	(5,682)
Provisions	(208)	(322)	(1,079)	(1,389)
Accrual for performance guarantees	(745)	1,034	(1,410)	(618)
	<u>(4,315)</u>	<u>2,225</u>	<u>544</u>	<u>(3,980)</u>

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

12 Related party transactions and balances

Transactions and balances with related parties are in the ordinary course of business. Related party transactions and balances not otherwise disclosed separately in these consolidated financial statements are as follows:

	Six-month periods ended August 31,	
	2019	2018
	\$	\$
Affiliated company owned by certain relatives of the controlling shareholder		
Purchases – Material components	408	594
Key management ¹ compensation		
Salaries and other short-term benefits	2,341	2,066
Share-based compensation – Options	2	9
Share-based compensation – PSUs and DSUs	(15)	27
	August 31,	February 28,
	2019	2019
	\$	\$
Accounts payable and accrued liabilities		
Affiliated companies	113	98

¹ Key management includes directors (executive and non-executive) and certain senior management.

A world leader in industrial valve manufacturing supplying to:

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- Chemicals
- Pulp and paper
- Subsea
- LNG and cryogenics
- Marine
- Mining
- HVAC
- Water and wastewater

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Velan Inc. is listed on the Toronto stock exchange under the symbol VLN

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