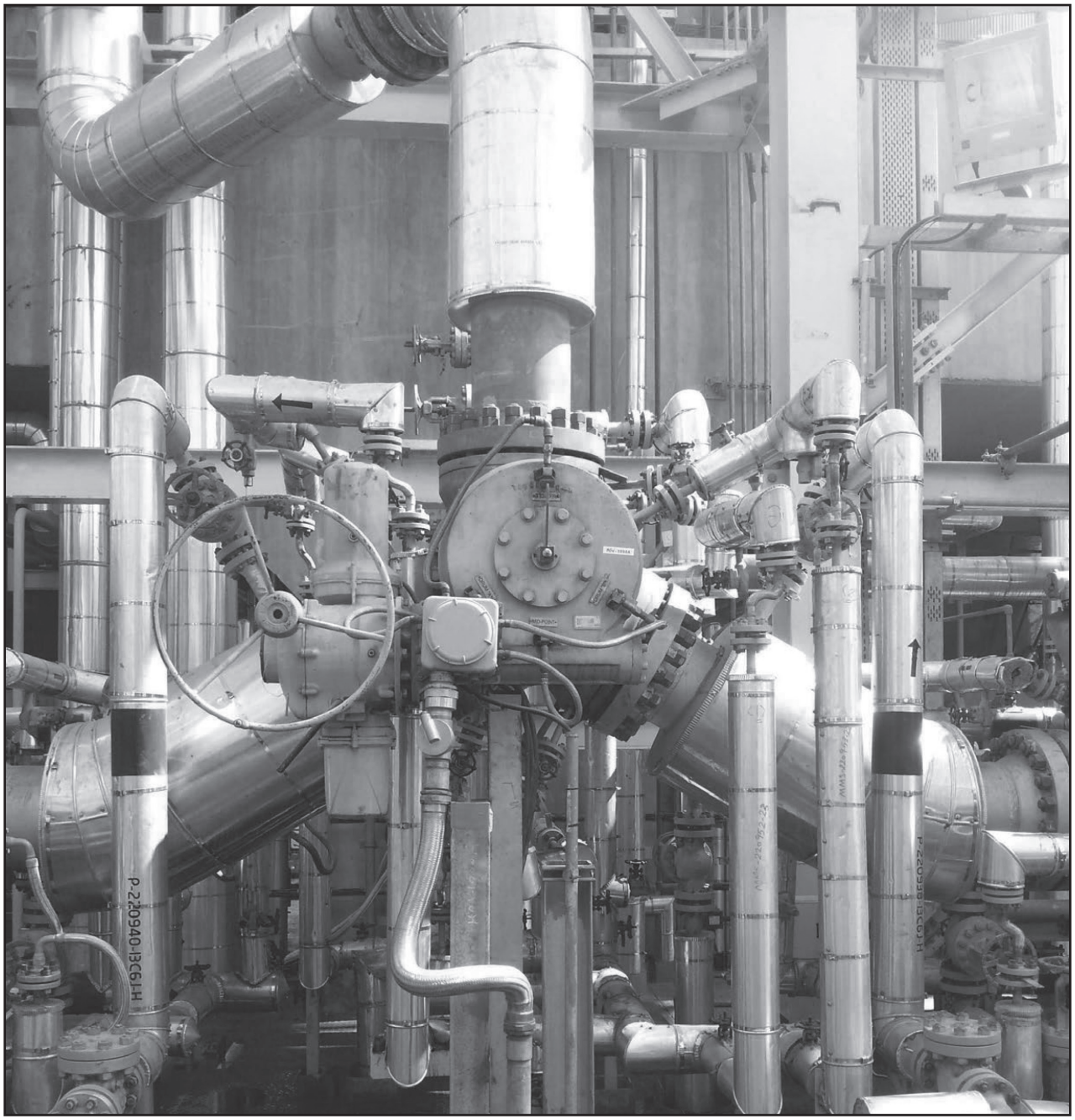
Report to shareholders

First quarter

Three month period ended May 31, 2020



VELAN

Quality that lasts.

VELAN

Management's Discussion and Analysis

1st QUARTER ENDED MAY 31, 2020

July 9, 2020

The following discussion provides an analysis of the consolidated operating results and financial position of Velan Inc. ("the Company") for the quarter ended May 31, 2020. 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 29, 2020 and February 28, 2019. The Company's consolidated financial statements have been prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS"). The significant accounting policies upon which these consolidated financial statements have been prepared are detailed in Note 2 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 first quarter unaudited condensed consolidated financial statements is detailed in Note 1 of the Company's audited consolidated financial statements for the years ended February 29, 2020 and February 28, 2019.

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 1,683 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.

VELAN

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 HIGHLIGHTS[1]

(millions, excluding per share amounts)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019	Increase (decrease)	% Increase (decrease)
Consolidated statements of earnings				
Sales	$76.7	$83.8	$(7.1)	(8.5)%
Gross profit	18.4	16.1	2.3	14.3%
Gross profit %	24.0%	19.2%		
Net loss[2]	1.9	5.8	(3.9)	(67.2)%
Net loss[2] %	2.5%	6.9%		
Net loss[2] per share – basic and diluted	0.09	0.27	(0.18)	(66.7)%
Operating profit (loss) before restructuring and transformation costs[3]	0.7	(6.8)	7.5	110.3%
Adjusted EBITDA[3]	3.8	(3.8)	7.6	200.0%
Adjusted EBITDA[3] %	5.0%	(4.5)%		
Adjusted EBITDA[3] per share – basic and diluted	0.18	(0.18)	0.36	200.0%
Weighted average shares outstanding	21.6	21.6		
Consolidated statements of cash flows				
Cash provided by operating activities	19.2	1.7	17.5	1,029.4%
Cash used in investing activities	3.9	0.7	3.2	457.1%
Cash used in financing activities	2.7	2.0	0.7	35.0%
Demand data				
Net new orders received	76.7	64.2	12.5	19.5%
Period ending backlog of orders	410.3	423.3	(13.0)	(3.1)%

[1] *All dollar amounts in this schedule are denominated in U.S. dollars.*
[2] *Net earnings or loss refer to net income or loss attributable to Subordinate and Multiple Voting Shares.*
[3] *Non-IFRS measures – see reconciliations at the end of this report*

Management's Discussion and Analysis

Highlights for the three-month period ended May 31, 2020

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

- Sales amounted to $76.7 million, a decrease of $7.1 million or 8.5% from the prior year. Sales were negatively impacted by a decrease in shipments from the Company's North American and French operations, which was partially offset by an increase in shipments from the Company's Italian operations. The decreased sales volume for the quarter is attributable to a lower shippable backlog in the Company's North American operations, combined with the negative impact that the novel coronavirus ("COVID-19") pandemic had on the global economy. For example, the Company had to manage many disruptions related to its supply chain which caused significant delays on certain customer orders, and due to travel restrictions, experienced difficulties in getting inspection clearance to deliver certain large project orders. Finally, the Company was able during the quarter to obtain recognition by most governments of its status as supplier of critical equipment to essential industries and as a result was able to maintain its operations while managing through the pandemic. However, the Company did nevertheless face government mandated temporary shutdowns in reaction to the spread of the virus in certain regions of the world, in particular in India and Italy. The Company's Italian operations, though faced with these challenges, were able to deliver a strong quarter in terms of large project orders shipments.
- Gross profit percentage increased by 480 basis points from 19.2% to 24.0%. Despite the lower sales volume, the increase in gross profit percentage was mainly attributable to a product mix with a greater proportion of higher margin product sales as well as labour and overhead savings stemming from the Company's restructuring and transformation initiatives which started in the prior fiscal year. The increase is also attributable to the Company's qualification for $1.9 million of wage subsidies. The subsidies were put in place by government authorities to prevent further job losses in the context of the COVID-19 pandemic by offering wages relief to companies negatively impacted by the market distress caused by the virus. This increase was partially offset by a lower gross profit percentage in the Company's French operations due to lower shipments of large project orders for the quarter.
- Administration costs amounted to $17.7 million, a decrease of $5.3 million or 23.0% compared to last year. The decrease is primarily attributable to the on-going effort to reduce administration overhead expenses under the V20 plan, a $1.5 million reduction of administration employee salaries provided by wage subsidies as well as a general reduction in administration expenses, such as travel expenses and office maintenance costs, caused principally by the downturn of the market conditions as well as the lockdowns that were enforced in a majority of countries over the course of the quarter. The Company had also recorded, in the prior year, a $0.9 million final settlement relating to a long-standing product claim that was filed against the Company.
- Net loss[1] amounted to $1.9 million or $0.09 per share compared to $5.8 million or $0.27 per share last year. The decrease in net loss[1] is primarily attributable to the Company's improved gross profit as well as lowered administration costs, which was partially offset by an increase in restructuring and transformation costs combined with an unfavorable movement in income taxes (see *Results of operations* section).
- Operating profit before restructuring and transformation costs[2] amounted to $0.7 million compared to an operating loss before restructuring and transformation costs[2] of $6.8 million last year. Adjusted EBITDA[2] amounted to $3.8 million or $0.18 per share compared to a negative $3.8 million or a negative $0.18 per share last year. The improvement in operating profit before restructuring and transformation costs[2] and adjusted EBITDA[2] is primarily attributable to a stronger gross profit, driven by a range of V20 initiatives and a better product mix, as well as lowered administration costs.

[1] *Net earnings or loss refer 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

- During the quarter, the Company listed one of its Montreal plants for sale through the scope of its restructuring and transformation plan. As a result, the carrying value of this plant is presented as an asset held for sale. Subsequent to the end of the quarter, the Company agreed to the sale of its Montreal plant on MacArthur Street in Saint-Laurent, Quebec, which will be effective on October 31, 2020. The closing of the plant was planned as part of the V20 reconfiguration of the Company's North American manufacturing footprint. Gross proceeds will be $12.6M and are conditional upon the submission of a clean Bill 72 environmental report to the Quebec authorities. Additionally, the Company secured, shortly after the end of the quarter, new financing in the form of a $22.5M mortgage loan and a $65.0M revolving credit facility which will be used to support the Company's operations, to complete its restructuring and transformation plan as well as to provide the necessary capital to pursue future growth initiatives while strengthening its balance sheet as the world economy enters a period of uncertainty.
- Net new orders received ("bookings") amounted to $76.7 million, an increase of $12.5 million or 19.5% compared to last year. This increase is primarily attributable to large project orders booked in the Company's North American, German, French and Italian operations, notably in the liquified natural gas and nuclear markets. This increase was partially offset by a decrease in the non-project orders booked in the Company's North American operations due to the unfavorable market conditions caused by the COVID-19 pandemic affecting the Company's distribution channel. The Company was encouraged nonetheless to record a 19.5% increase in bookings in the current context when compared to last year.
- The Company ended the period with a backlog of $410.3 million, an increase of $3.5 million or 0.9% since the beginning of the current fiscal year. The increase in backlog is primarily attributable to the strengthening of the euro spot rate against the U.S. dollar over the course of the current quarter.
- The Company ended the quarter with net cash of $44.6 million, an increase of $13.6 million or 43.9% since the beginning of the current fiscal year. This increase is primarily attributable to cash provided by operating activities, mainly due to strong working capital management, and the favorable movements of the Euro and Canadian dollar spot rates, against the U.S. dollar, on the net cash balance of the Company over the course of the current quarter. The increase was partially offset by short-term investments, additions to property, plant and equipment, dividend payments to shareholders and repayments of short-term bank loans, long-term debt and long-term lease liabilities.
- Foreign currency impacts:
    - Despite the increase of the Euro spot rate over the course of the quarter, the average exchange rates of the Euro weakened 2.7% 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 4.2% 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 was generally favorable on the Company's net loss[1].

[1] *Net earnings or loss refer to net income or loss attributable to Subordinate and Multiple Voting Shares.*

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							
	May 2020	**February 2020**	**November 2019**	**August 2019**	**May 2019**	**February 2019**	**November 2018**	**August 2018**
Sales	$76,653	$113,641	$88,701	$85,467	$83,816	$105,345	$92,271	$91,375
Net earnings (loss)[1]	(1,886)	(11,116)	(819)	1,369	(5,824)	1,519	(236)	(2,438)
Net earnings (loss)[1] per share								
- Basic and diluted	(0.09)	(0.51)	(0.04)	0.06	(0.27)	0.07	(0.01)	(0.11)

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 2020 and August 2018 due to increased shipments of such orders, while the lower sales amounts for the quarters ended in May 2019, August 2019 and November 2019 were due to delays on the shipments of such orders. Sales were higher in the quarters ended in February 2019 and November 2018 due to increased shipments of a large project order in China, but, more significantly, as a result of a large surge in the MRO business. Sales were lower in the quarter ended in May 2020 due to a lower backlog, as well as the many disruptions caused by the COVID-19 pandemic. Net earnings[1] for the quarter ended in February 2019 was higher due to an improved sales volume and a more profitable product mix. The net loss[1] 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 earnings[1] for the quarter ended August 2019 was due to a more profitable product mix. The net loss[1] for the quarters ended in August 2018 and November 2018 were largely due to the fact that the North American operations were below break even and additional costs were incurred in the quarter to meet delivery commitments. The net loss[1] for the quarter ended in February 2020 was due to the de-recognition of unused tax losses as well as the $7.1 million spent on the Company's restructuring and transformative initiative, V20. The net loss[1] for the quarter ended in May 2020 was due to a lower sales volume, the expenses incurred by the Company in the scope of its restructuring and transformation plan as well as unrecognized tax losses, primarily in the Company's North American operations.

[1] *Net earnings or loss refer to net income or loss attributable to Subordinate and Multiple Voting Shares.*

Management's Discussion and Analysis

RESULTS OF OPERATIONS – quarter ended May 31, 2020 compared to the quarter ended May 31, 2019 *(unless otherwise noted, all amounts are in U.S. dollars and all comparisons are to the first quarter of the last fiscal year)*

Sales

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Sales	$76.7	$83.8

Sales decreased by $7.1 million or 8.5% for the quarter. Sales were negatively impacted by a decrease in shipments from the Company's North American and French operations, which was partially offset by an increase in shipments from the Company's Italian operations. The decreased sales volume for the quarter is attributable to a lower shippable backlog in the Company's North American operations, combined with the negative impact that the novel coronavirus ("COVID-19") pandemic had on the global economy. For example, the Company had to manage many disruptions related to its supply chain which caused significant delays on certain customer orders, and due to travel restrictions, experienced difficulties in getting inspection clearance to deliver certain large project orders. Finally, the Company was able during the quarter to obtain recognition by most governments of its status as supplier of critical equipment to essential industries and as a result was able to maintain its operations while managing through the pandemic. However, the Company did nevertheless face government mandated temporary shutdowns in reaction to the spread of the virus in certain regions of the world, in particular in India and Italy. The Company's Italian operations, though faced with these challenges, were able to deliver a strong quarter in terms of large project orders shipments.

Bookings and backlog

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Bookings	$76.7	$64.2

Bookings increased by $12.5 million or 19.5% compared to the same quarter last year. This increase is primarily attributable to large project orders booked by the Company's North American, German, French and Italian operations. This increase was partially offset by lower non-project orders recorded in the Company's North American operations due to the unfavorable market conditions caused by the COVID-19 pandemic affecting the Company's distributor channel. The Company was encouraged nonetheless to record a 19.5% increase in bookings in the current context when compared to last year.

(millions)	**May 2020**	**February 2020**	**May 2019**
Backlog	$410.3	$406.8	$423.3
For delivery within the next twelve months	$261.0	$257.5	$282.4
For delivery beyond the next twelve months	$149.3	$149.3	$140.9
Percentage – beyond the next twelve months	36.4%	36.7%	33.3%

Management's Discussion and Analysis

As a result of sales and bookings being virtually the same in the current quarter, the Company's book-to-bill ratio was 1.00 for the period. Furthermore, the total backlog increased by $3.5 million or 0.9% since the beginning of the fiscal year, settling at $410.3 million. The backlog was positively impacted by the strengthening of the euro spot rate against the U.S. dollar over the course of the current quarter.

Gross profit

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Gross profit	$18.4	$16.1
Gross profit percentage	24.0%	19.2%

Gross profit increased by $2.3 million or 14.3% compared to the same quarter last year, while the gross profit percentage increased by 480 basis points from 19.2% to 24.0%. Despite the lower sales volume, the increase in gross profit percentage was mainly attributable to a product mix with a greater proportion of higher margin product sales as well as labour and overhead savings stemming from the restructuring and transformation initiatives which started to be implemented in the prior fiscal year. The increase is also attributable to the Company's qualification for $1.9 million of wage subsidies. The subsidies were put in place by government authorities to prevent further job losses in the context of the COVID-19 pandemic by offering wages relief to companies negatively impacted by the market distress caused by the virus. This increase was partially offset by a lower gross profit percentage in the Company's French operations due to lower shipments of large project orders for the quarter.

Administration Costs

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Administration Costs*	$17.7	$23.0
As a percentage of sales	23.1%	27.4%
*Includes asbestos-related costs of:	$2.0	$2.0

Administration costs decreased by $5.3 million or 23.0%. The decrease is primarily attributable to the on-going effort to reduce administration overhead expenses under the V20 plan, a $1.5 million reduction of administration employee salaries provided by wage subsidies as well as a general reduction in administration expenses, such as travel expenses and office maintenance costs, caused principally by the downturn of the market conditions as well as the lockdowns that were enforced in the majority of countries over the course of the quarter. The Company had also recorded, in the prior year, a $0.9 million final settlement relating to a long-standing product claim that was filed against the Company.

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.

Income taxes

(in thousands, excluding percentages)	Three-month period ended May 31, 2020 $	%	Three-month period ended May 31, 2019 $	%
Income tax at statutory rate of 26.6% (May 31, 2019 - 26.7%)	(210)	26.6	(2,038)	26.7
Tax effects of:				
Difference in statutory tax rates in foreign jurisdictions	85	(10.7)	(38)	0.5
Non-deductible foreign exchange losses	131	(16.6)	329	(4.3)
Unrecognized tax losses	1,222	(154.5)	221	(2.9)
Losses utilized not previously tax effected	-	-	(170)	2.2
Benefit attributable to a financing structure	(61)	7.7	(222)	2.9
Other differences	(54)	6.8	99	(1.3)
Income tax expense (recovery)	1,113	(140.7)	(1,819)	23.8

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

Net loss[1], Operating profit (loss) before restructuring and transformation costs[2], Adjusted EBITDA[2]

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Net loss[1]	$1.9	$5.8
As a percentage of sales	(2.5)%	(6.9)%
Operating profit (loss) before restructuring and transformation costs[2]	$0.7	$(6.8)
Adjusted EBITDA[2]	$3.8	$(3.8)
As a percentage of sales	5.0%	(5.1)%

Net loss[1] amounted to $1.9 million or $0.09 per share compared to $5.8 million or $0.27 per share last year. The decrease in net loss[1] is primarily attributable to the Company's improved gross profit as well as lowered administration costs, which was partially offset by an increase in restructuring and transformation costs combined with an unfavorable movement in income taxes. Operating profit before restructuring and transformation costs[2] amounted to $0.7 million compared to an operating loss before restructuring and transformation costs[2] of $6.8 million last year. Adjusted EBITDA[2] amounted to $3.8 million or $0.18 per share compared to a negative $3.8 million or a negative $0.18 per share last year. The improvement in operating profit before restructuring and transformation costs[2] and adjusted EBITDA[2] is primarily attributable to a stronger gross profit, driven by a range of V20 initiatives and a better product mix, as well as lowered administration costs.

[1] *Net earnings or loss refer to net income or loss attributable to Subordinate and Multiple Voting Shares.*
[2] *Non-IFRS measures – see reconciliations at the end of this report.*

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)	As at May 31, 2020					
	Carrying value $	**Less than 1 year $**	**1 to 3 Years $**	**4 to 5 Years $**	**After 5 years $**	**Total $**
Long-term debt	18,423	8,143	5,350	3,144	2,164	18,801
Long-term lease Liabilities	15,346	1,958	3,036	2,244	13,189	20,427
Accounts payable and accrued liabilities	63,893	63,893	-	-	-	63,893
Customer deposits	51,086	51,086	-	-	-	51,086
Bank indebtedness and short-term bank loans	40,183	40,183	-	-	-	40,183
Derivative liabilities	2,006	2,006	-	-	-	2,006

On May 31, 2020, the Company's order backlog was $410.3 million and its net cash plus unused credit facilities amounted to $112.9 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 suppliers.

The Company secured, shortly after the end of the quarter, new financing in the form of a $22.5M mortgage loan and a $65.0M revolving credit facility which will be used to support the Company's operations, to complete its restructuring and transformation plan as well as to provide the necessary capital to pursue future growth initiatives, while strengthening its balance sheet as the world economy enters a period of uncertainty.

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.

Cash flows - quarter ended May 31, 2020 compared to the quarter ended May 31, 2019

(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)	May 31, 2020	February 29, 2020	May 31, 2019
Net cash	$44.6	$31.0	$39.4

The Company's net cash increased by $13.6 million or 43.9% during the quarter. This increase is primarily attributable to cash provided by operating activities, due to strong working capital management, and the favorable movements of the Euro and Canadian dollar spot rates, against the U.S. dollar, on the Company's net cash balance over the course of the quarter. The increase was partially offset by short-term investments, additions to property, plant and equipment, dividend payments to shareholders and repayments of short-term bank loans, long-term debt and long-term lease liabilities.

Cash provided by operating activities

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Cash provided by operating activities	$19.2	$1.7

Cash provided by operating activities amounted to $19.2 million for the current quarter compared to $1.7 million in the prior year. The current quarter's source of funds consisted of a net earnings[1] of $2.7 million when adjusted for non-cash items and positive non-cash working capital movements of $16.5 million, which consisted primarily of a decrease in accounts receivable and inventory as well as an increase of customer deposits, partially offset by a decrease in accounts payable and accrued liabilities.

Accounts receivable

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Accounts receivable decrease	$18.6	$14.7

Accounts receivable balances are a function of the timing of sales and cash collections. The accounts receivable balance decreased in the current quarter due primarily to the increased collection of prior year sales.

Inventories

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Inventories decrease (increase)	$5.0	$(5.9)
Customer deposits increase (decrease)	$3.3	$(1.1)

[1] *Net earnings or loss refer to net income or loss attributable to Subordinate and Multiple Voting Shares.*

The inventories decreased in the current quarter due to the strong shipping quarter the Company had to end the prior fiscal year combined with certain stock replenishment delays caused by the current market condition. 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 due to higher customer deposits on certain large project orders in the Company's French operations.

Accounts payable and accrued liabilities

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Accounts payable and accrued liabilities (decrease) increase	$(10.3)	$1.5

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

Additions to property, plant and equipment

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Additions to property, plant and equipment	$2.5	$0.7

The increase in additions to property, plant and equipment for the current quarter is primarily attributable to the Company's restructuring and transformation initiative, V20 as well as the timing of the receipts of certain equipment.

Dividends

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Dividends paid	$0.5	$0.5

At the end of the fiscal year ended February 29, 2020, the Board of Directors deemed appropriate to suspend the quarterly dividend. The decision remains unchanged and will be reviewed on a quarterly basis.

Long-term debt and long-term lease liabilities

(millions)	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Repayment of long-term debt	$0.8	$0.7
Repayment of long-term lease liabilities	$0.4	$0.4

During the current quarter, the Company continued to pay down its outstanding long-term debt and lease obligations without undertaking any new debt issuances or significant new lease agreements.

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:

	Risks			
	Market			
Financial instrument	**Currency**	**Interest rate**	**Credit**	**Liquidity**
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
Derivative liabilities	x			x
Long-term debt	x	x		x

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 May 31, 2020 and February 29, 2020 are as follows:

	Range of exchange rates		Gain (loss) (In thousands of U.S. dollars)		Notional amount (In thousands of indicated currency)	
	May 31, 2020	February 29, 2020	May 31, 2020 $	February 29, 2020 $	May 31, 2020	February 29, 2020
Foreign exchange forward contracts						
Sell US$ for CA$ – 0 to 12 months	1.33-1.34	1.33-1.34	(1,921)	(923)	US$51,000	US$68,000
Buy US$ for CA$ – 0 to 12 months	1.31-1.33	1.31-1.33	8	357	US$51,000	US$68,000
Buy US$ for € – 0 to 12 months	1.08-1.11	1.10-1.11	(3)	(3)	US$1,210	US$1,205
Sell € for US$ – 0 to 12 months	1.11-1.14	1.11-1.14	(53)	(174)	€15,410	€16,790
Buy € for US$ – 0 to 12 months	1.10-1.11	1.10-1.11	117	198	€15,410	€16,790
Sell US$ for KW – 0 to 12 months	1,162-1,166	1,139-1,171	(30)	(70)	US$1,210	US$1,647
Total Gain (loss)			**(1,882)**	**(615)**		

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 May 31, 2020, five (February 29, 2020 – four) customers accounted for more than 5% each of its trade accounts receivable, of which one customer accounted for 17.0% (February 29, 2020 – 15.0%), and the Company's ten largest customers accounted for 65.6% (February 29, 2020 – 61.2%) of trade accounts receivable. In addition, there was one (February 29, 2020 – two) customer that accounted for more than 10% of the Company's sales.

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)	**May 31, 2020 $**	**February 29, 2020 $**
Current	57,438	83,711
Past due 0 to 30 days	11,960	16,619
Past due 31 to 90 days	17,275	7,445
Past due more than 90 days	23,279	21,989
	109,952	129,764
Less: Allowance for doubtful accounts	1,787	2,002
Trade accounts receivable	108,165	127,762
Other receivables	9,147	7,480
Total accounts receivable	117,312	135,242

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

(In thousands of U.S. dollars)	**May 31, 2020 $**	**May 31, 2019 $**
Balance – Beginning of year	2,002	1,662
Bad debt expenses	3	10
Write-off of trade accounts receivable	(212)	(28)
Foreign exchange	(6)	164
Balance – End of year	1,787	1,808

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

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. 1,583 claims were outstanding at the end of the reporting period (February 29, 2020 – 1,561). These claims were filed in the states of Arizona, California, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, Texas, Virginia, Washington, Wisconsin and West Virginia. During the reporting period, the Company resolved 73 claims (May 31, 2019 – 88) and was the subject of 95 new claims (May 31, 2019 – 156). 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 $2,046 (May 31, 2019 - $2,028) in the quarter.

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 months ended May 31	
	2020	2019
Purchases of material components	$147	$217

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.

INTERNAL CONTROLS AND PROCEDURES

In accordance with National Instrument 52-109 – Certification of Disclosure in Issuer's Annual and Interim Filings, disclosure controls and procedures have been designed to provide reasonable assurance that the information presented in the Company's interim and annual reports to shareholders is accumulated and communicated to management on a timely basis, including the Chief Executive Officer and the Chief Financial Officer, in order for appropriate decisions to be made in regards to disclosures. Internal controls over financial reporting have also been designed to provide reasonable assurance regarding the reliability of the financial reporting and the preparation of financial statements in accordance with IFRS.

The Company did not make any changes to the design of internal controls over financial reporting during the three-month period ended May 31, 2020 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 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.

CERTAIN RISKS THAT COULD AFFECT OUR BUSINESS

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

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 29, 2020	Fiscal year ended February 28, 2019	Fiscal year ended February 28, 2018
Operating Data			
Sales	$371,625	$366,865	$337,963
Net loss[1]	(16,390)	(4,882)	(17,811)
Loss per Share			
- Basic and diluted	(0.76)	(0.23)	(0.82)
Balance Sheet Data			
Total Assets	538,496	524,357	540,193
Total Long-Term Financial Liabilities	19,609	21,723	22,200
Shareholder Data			
Cash dividends per share			
- Multiple Voting Shares[2]	0.09	0.09	0.31
- Subordinate Voting Shares	0.09	0.09	0.31
Outstanding Shares at report date			
- Multiple Voting Shares[2]	15,566,567		
- Subordinate Voting Shares	6,019,068		

Sales for fiscal year 2020 increased by 1.3% compared to fiscal year 2019. This increase was primarily attributable to an increase in shipments from the Company's Italian operations which continued to deliver the record backlog, destined to the upstream oil and gas industry. This increase was partially offset by decreased shipments from the Company's North American and French operations. The decrease in shipments from the Company's North American operations is primarily attributable to an unusually high surge of non-project valve restocking orders from its distributors in the first quarter of the prior fiscal year. 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.

Gross profit for fiscal year 2020 amounted to $88.1 million, an increase of $2.5 million from fiscal year 2019, while the gross profit percentage increased from the 23.3% reported in fiscal year 2019 to 23.7% in fiscal year 2020. This reflected a much-improved performance in the last three quarters of the year, each delivering above 24% in gross profit, a notable recovery from the first quarter where gross profit was only 19.2%. The recovery came from the strong sales volume and higher margin sales in the Company's European operations. Meanwhile, on a full-year comparison basis, this increase was partially offset by the lower sales volume shipped by the Company's North American operations. The gross profit percentage was also negatively impacted by the very low margins experienced in the first quarter in the Company's North American operations. However, these saw an overall improvement in margins through the last three quarters, thanks to the reduction of its production overhead in accordance with the V20 plan, a better mix, and its business units' increased focus on higher quality orders. 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.

Administration costs for fiscal year 2020 decreased by $8.1 million when compared to fiscal year 2019. This decrease was attributable to lower sales commissions and freight charges as well as benefiting from the reduction of staff levels, for which the related retirement packages were recorded in the last quarter of the previous year. This decrease was partially offset by a $0.9 million expense regarding the settlement of a product claim that was filed against the Company in a prior year as well as a slight increase in costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section). 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 the assessment of its current restructuring and transformation initiative, V20. The Company also experienced an increase in costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section).

[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.*

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 measures can be found below.

Operating profit (loss) before restructuring and transformation costs and Adjusted net earnings (loss) before interest, taxes, depreciation and amortization ("EBITDA")

	Three-month period ended May 31, 2020	Three-month period ended May 31, 2019
Operating loss	(0.5)	(7.3)
Adjustment for:		
Restructuring and transformation costs	1.2	0.5
Operating profit (loss) before restructuring and transformation costs	**0.7**	**(6.8)**
Net loss[1]	(1.9)	(5.8)
Adjustments for:		
Depreciation of property, plant and equipment	2.5	2.6
Amortization of intangible assets	0.6	0.4
Finance costs – net	0.3	0.3
Income taxes	1.1	(1.8)
EBITDA	**2.6**	**(4.3)**
Adjustment for:		
Restructuring and transformation costs	1.2	0.5
Adjusted EBITDA	**3.8**	**(3.8)**

The term "operating profit or loss before restructuring and transformation costs" is defined as operating profit or loss plus restructuring and transformation costs. The forward-looking statements contained in this MD&A are expressly qualified by this cautionary statement.

The term "adjusted EBITDA" is defined as net income or loss attributable to Subordinate and Multiple Voting Shares plus restructuring and transformation costs, depreciation of property, plant & equipment, plus amortization of intangible assets, plus net finance costs plus income tax provision. The forward-looking statements contained in this MD&A are expressly qualified by this cautionary statement.

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

Velan Inc.

Unaudited Condensed Interim Consolidated Financial Statements
For the three-month period ended May 31, 2020

Notice of No Auditor Review of Condensed 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 period ended May 31, 2020

Velan Inc.

Condensed Interim Consolidated Statements of Financial Position

(Unaudited)

(in thousands of U.S. dollars)

As At	May 31, 2020 $	February 29, 2020 $
Assets		
Current assets		
Cash and cash equivalents	84,426	75,327
Short-term investments	1,764	627
Accounts receivable	117,312	135,242
Income taxes recoverable	7,980	8,747
Inventories (note 5)	166,042	170,265
Deposits and prepaid expenses	6,217	5,191
Derivative assets (note 9)	124	555
Assets held for sale (note 6)	3,512	-
	387,377	395,954
Non-current assets		
Property, plant and equipment	94,661	98,179
Intangible assets and goodwill	17,036	17,148
Deferred income taxes	25,986	26,702
Other assets	529	513
	138,212	142,542
Total assets	525,589	538,496
Liabilities		
Current liabilities		
Bank indebtedness	39,786	44,317
Short-term bank loans	397	1,379
Accounts payable and accrued liabilities	63,893	74,271
Income taxes payable	1,965	1,493
Customer deposits	51,086	47,208
Provisions	15,608	14,963
Provision for performance guarantees	20,604	21,127
Derivative liabilities (note 9)	2,006	1,169
Current portion of long-term lease liabilities	1,617	1,621
Current portion of long-term debt	8,013	8,311
	204,975	215,859
Non-current liabilities		
Long-term lease liabilities	13,729	13,722
Long-term debt	10,410	10,986
Income taxes payable	1,576	1,576
Deferred income taxes	2,758	2,869
Other liabilities	8,280	8,623
	36,753	37,776
Total liabilities	241,728	253,635
Total equity	283,861	284,861
Total liabilities and equity	525,589	538,496

Contingencies (note 8)

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

Velan Inc.

Condensed Interim Consolidated Statements of Loss

(Unaudited)

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

	Three-month periods ended May 31	
	2020	**2019**
	$	**$**
Sales (note 11)	76,653	83,816
Cost of sales (notes 5)	58,261	67,722
Gross profit	18,392	16,094
Administration costs	17,667	22,954
Restructuring and transformation costs (note 14)	1,176	509
Other expense (income)	24	(57)
Operating loss	(475)	(7,312)
Finance income	116	140
Finance costs	434	467
Finance costs – net	(318)	(327)
Loss before income taxes	(793)	(7,639)
Income Taxes	1,113	(1,819)
Net loss for the period	(1,906)	(5,820)
Net loss attributable to:		
Subordinate Voting Shares and Multiple Voting Shares	**(1,886)**	**(5,824)**
Non-controlling interest	(20)	4
	(1,906)	(5,820)
Net loss per Subordinate and Multiple Voting Share		
Basic	(0.09)	(0.27)
Diluted	(0.09)	(0.27)
Dividends declared per Subordinate and Multiple Voting Share	- (CA$ -)	0.02 (CA$0.03)
Total weighted average number of Subordinate and Multiple Voting Shares		
Basic	21,585,635	21,621,935
Diluted	21,585,635	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 Loss

(Unaudited)
(in thousands of U.S. dollars)

	Three-month periods ended May 31	
	2020	**2019**
	$	**$**
Comprehensive loss		
Net loss for the period	(1,906)	(5,820)
Other comprehensive income (loss)		
Foreign currency translation adjustment on foreign operations whose functional currency is other than the reporting currency (U.S. dollar)	906	(2,851)
Comprehensive loss	(1,000)	(8,671)
Comprehensive loss attributable to:		
Subordinate Voting Shares and Multiple Voting Shares	(930)	(8,537)
Non-controlling interest	(70)	(134)
	(1,000)	(8,671)

Other comprehensive income (loss) is composed solely of items that may be reclassified subsequently to the consolidated statement of 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							
	Number of shares	Share capital (note 7)	Contributed surplus	Accumulated other comprehensive income (loss)	Retained earnings	Total	Non-controlling interest	Total equity
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 year	-	-	-	-	(5,824)	(5,824)	4	(5,820)
Other comprehensive loss	-	-	-	(2,713)	-	(2,713)	(138)	(2,851)
Effect of share-based compensation (note 7 (d))	-	-	1	-	-	1	-	1
Dividends								
Multiple Voting Shares	-	-	-	-	(346)	(346)	-	(346)
Subordinate Voting Shares	-	-	-	-	(135)	(135)	-	(135)
Balance - May 31, 2019	21,621,935	73,090	6,075	(31,703)	248,301	295,763	3,919	299,682
Balance - February 29, 2020	21,585,635	72,695	6,260	(34,047)	236,269	281,177	3,684	284,861
Net loss for the year	-	-	-	-	(1,886)	(1,886)	(20)	(1,906)
Other comprehensive income (loss)	-	-	-	956	-	956	(50)	906
Balance - May 31, 2020	21,585,635	72,695	6,260	(33,091)	234,383	280,247	3,614	283,861

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 May 31	
	2020	**2019**
	$	**$**
Cash flows from		
Operating activities		
Net loss for the period	(1,906)	(5,820)
Adjustments to reconcile net loss to cash provided by operating activities (note 12)	4,626	2,683
Changes in non-cash working capital items (note 13)	16,523	4,859
Cash provided by operating activities	19,243	1,722
Investing activities		
Short-term investments	(1,137)	(4)
Additions to property, plant and equipment	(2,531)	(748)
Additions to intangible assets	(257)	(22)
Proceeds on disposal of property, plant and equipment, and intangible assets	40	32
Net change in other assets	(22)	13
Cash used by investing activities	(3,907)	(729)
Financing activities		
Dividends paid to Subordinate and Multiple Voting shareholders	(482)	(476)
Short-term bank loans	(982)	(439)
Repayment of long-term debt	(759)	(716)
Repayment of long-term lease liabilities	(431)	(396)
Cash used by financing activities	(2,654)	(2,027)
Effect of exchange rate differences on cash	948	(435)
Net change in cash during the period	13,630	(1,469)
Net cash – Beginning of the period	31,010	40,866
Net cash – End of the period	44,640	39,397
Net cash is composed of:		
Cash and cash equivalents	84,426	72,597
Bank indebtedness	(39,786)	(33,200)
	44,640	39,397
Supplementary information		
Interest received (paid)	(348)	279
Income taxes received (paid)	(555)	1,831

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

For the three-month period ended May 31, 2020

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 July 9, 2020. 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 period ended May 31, 2020 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 29, 2020, 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 29, 2020.

3 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 29, 2020.

4 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. However, the occurrence of certain events that are beyond the Company's control, such as the COVID-19 pandemic, may cause disruptions in its global operations that could materially adversely affect the business and financial results of the Company. Consequently, the results for the three-month period ended May 31, 2020 may not be representative when compared to prior or subsequent quarters or for the full fiscal year.

During the three-month period ended May 31, 2020, the company has qualified for wage subsidies which provided a reduction of salaries of $1,895 in Cost of sales, $1,565 in Administration costs and $144 in Restructuring and transformation costs.

5 Inventories

	May 31, 2020 $	February 29, 2020 $
Raw materials	38,449	35,920
Work in process	95,157	95,123
Finished goods	32,436	39,222
	166,042	170,265

As a result of variations in the ageing of its inventories, the Company recognized a net additional inventory provision for the three-month period ended May 31, 2020 of $523 (May 31, 2019 - $1,246), including reversals of $1,378 (May 31, 2019 - $1,075).

6 Assets held for sale

	May 31, 2020 $	February 29, 2020 $
Land	360	-
Building	2,476	-
Machinery & Equipment	676	-
	3,512	-

During the three-month period ended May 31, 2020, the Company listed one of its Montreal plants for sale through the scope of its restructuring and transformation plan. The Company's operations in this particular plant were not yet discontinued at the end of the three-month period ended May 31, 2020. The Company agreed to the sale of this plant following the end of the quarter. See note 15 on subsequent events for more information. Additionally, the Company's North American operations agreed to use the service of an auctioneer to dispose of some of the excess machinery and equipment that would not be required in the future.

7 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

	May 31, 2020 $	February 29, 2020 $
6,019,068 Subordinate Voting Shares	65,569	65,569
15,566,567 Multiple Voting Shares	7,126	7,126
	72,695	72,695

c) Pursuant to its Normal Course Issuer Bid, the Company is entitled to repurchase for cancellation a maximum of 151,384 of the issued Subordinate Voting Shares of the Company, representing approximately 2.5% of the issued shares of such class as at October 10, 2019, during the ensuing 12-month period ending October 22, 2020. No shares were repurchased for cancellation during the three-month periods ended May 31, 2020 and 2019.

d) 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 remaining outstanding options expired during the three-month period ended May 31, 2020.

e) On July 13, 2017, the Company adopted a PSU plan allowing the Board of Directors, through its Corporate Governance and Human Resources ("CGHR") Committee, to grant performance share units ("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.

As at May 31, 2020, the Company had no PSU's outstanding since they had all expired at the end of the prior fiscal year. As at May 31, 2019, the Company had a total of 24,691 PSUs outstanding, representing a total liability of $41 which is included in accounts payable and accrued liabilities. A compensation cost recovery of $28 was recorded in the consolidated statement of loss and decreased accounts payable and accrued liabilities. No payments were made, no PSUs were granted or forfeited, and no PSUs had vested during the three-month period ended May 31, 2019.

f) On July 13, 2017, the Company adopted a DSU plan allowing the Board of Directors, through its CGHR Committee, to grant deferred share units ("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 be deemed immediately vested, 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 shall vest on their grant date.

As at May 31, 2020, the Company had a total of 45,526 (February 29, 2020 – 45,268) DSUs outstanding, representing a total liability of $110 (February 29, 2020 – $127) which is included in accounts payable and accrued liabilities. A compensation cost recovery of $17 (May 31, 2019 – compensation cost of $8) was recorded in the consolidated statement of loss and decreased (May 31, 2019 – increased) accounts payable and accrued liabilities. No payments were made, no DSUs were granted or forfeited and no DSUs have vested during the three-month periods ended May 31, 2020 and 2019.

8 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 three-month period ended May 31, 2020, legal and related costs for these matters amounted to $2,046 (May 31, 2019 – $2,028).

9 Fair value of financial instruments

The fair value hierarchy has the following levels:

- Level 1 – quoted market prices in active markets for identical assets or liabilities;
- Level 2 – inputs other than quoted market prices included in Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices); and
- Level 3 – unobservable inputs such as inputs for the asset or liability that are not based on observable market data. The level in the fair value hierarchy within which the fair value measurement is categorized in its entirety is determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety.

The fair value of financial assets and financial liabilities measured on the consolidated statements of financial position are as follows:

	As at May 31, 2020			
Financial position classification and nature	**Total $**	**Level 1 $**	**Level 2 $**	**Level 3 $**
Assets				
Derivative assets	124	-	124	-
Liabilities				
Derivative liabilities	2,006	-	2,006	-

	As at February 29, 2020			
Financial position classification and nature	**Total $**	**Level 1 $**	**Level 2 $**	**Level 3 $**
Assets				
Derivative assets	555	-	555	-
Liabilities				
Derivative liabilities	1,169	-	1,169	-

Fair value measurements of the Company's derivative assets and liabilities are classified under Level 2 because such measurements are determined using published market prices or estimates based on observable inputs such as interest rates, yield curves, and spot and future exchange rates. The carrying value of the Company's financial instruments is considered to approximate fair value, unless otherwise indicated.

10 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:

	Three-month periods ended May 31,	
	2020	**2019**
	$	**$**
Affiliated company owned by certain relatives of the controlling shareholder		
Purchases – Material components	147	217
Key management[1] compensation		
Salaries and other short-term benefits	984	1,029
Share-based compensation – Options	-	1
Share-based compensation – PSUs and DSUs	(17)	(20)

	May 31, 2020	February 29, 2020
	$	**$**
Accounts payable and accrued liabilities		
Affiliated companies	67	91

11 Segment reporting

The Company reflects its results under a single reportable operating segment. The geographic distribution of its sales is as follows:

							May 31, 2020
	Canada	**United States**	**France**	**Italy**	**Other**	**Consolidated Adjustment**	**Consolidated**
	$	**$**	**$**	**$**	**$**	**$**	**$**
Sales							
Customers -							
Domestic	5,187	24,346	6,750	250	3,070	-	39,603
Export	9,294	-	5,736	18,123	3,897	-	37,050
Intercompany (export)	6,926	3,796	62	-	14,799	(25,583)	-
Total	21,407	28,142	12,548	18,373	21,766	(25,583)	76,653

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

							May 31, 2019
	Canada	United States	France	Italy	Other	Consolidated Adjustment	Consolidated
	$	$	$	$	$	$	$
Sales							
Customers -							
Domestic	11,365	24,210	8,555	754	5,826	-	50,710
Export	9,784	-	6,377	13,150	3,795	-	33,106
Intercompany (export)	11,627	4,595	-	309	14,767	(31,298)	-
Total	32,776	28,805	14,932	14,213	24,388	(31,298)	83,816

12 Adjustments to reconcile net loss to cash provided from operating activities

	Three-month periods ended May 31,	
	2020	2019
	$	$
Depreciation of property, plant and equipment	2,525	2,567
Amortization of intangible assets	568	452
Deferred income taxes	636	151
Share-based compensation expense (note 7 (d))	-	1
Loss (Gain) on disposal of property, plant and equipment	(20)	19
Net change in derivative assets and liabilities	1,262	325
Net change in other liabilities	(345)	(832)
	4,626	2,683

13 Changes in non-cash working capital items

	Three-month periods ended May 31,	
	2020	2019
	$	$
Accounts receivable	18,580	14,664
Inventories	5,004	(5,906)
Income taxes recoverable	757	(3,987)
Deposits and prepaid expenses	(979)	965
Accounts payable and accrued liabilities	(10,326)	1,500
Income taxes payable	457	266
Customer deposits	3,280	(1,107)
Provisions	542	(871)
Accrual for performance guarantees	(792)	(665)
	16,523	4,859

14 Restructuring and transformation costs

On January 10, 2019, the Company announced measures to improve its operational efficiency and optimize its manufacturing footprint in North America. The Company's production is gradually being reorganized from four North American plants to three more specialized plants that will be structured to better support the new business units' market strategies. The production of certain non-project valves produced in North America, as well as less complex project valves are also being transferred to India. The workforce reduction and plant consolidation commenced during the fourth quarter of the prior fiscal year and should be completed over the course of the current fiscal year.

During the current three-month period ended May 31, 2020, the Company incurred restructuring and transformation costs of $1,176 (May 31, 2019 – $509), which consisted primarily of project resources as well as the moving costs related to dismantling and transportation of machinery and equipment to reflect the optimized manufacturing footprint plan.

The Company has paid $1,117 worth of severance packages and related expenses during the three-month period ending May 31, 2020 which brought the provision to $4,369 as at May 31, 2020. All other restructuring and transformation costs are expensed as incurred.

15 Subsequent events

On July 3, 2020, the Company's North American operations secured new financing in the form of a $22,500 mortgage loan bearing monthly interest payments of 3.8% beginning in fiscal 2021 and payable over 20 years and in the form of a $65,000 revolving credit facility bearing interest at the 1-month Libor variable rate depending on excess availability and renewable every 3 years. The new financing structure will be subject to various covenants and certain limitations on dividend distributions. The new financing will be used to support the Company's operations, to complete its restructuring and transformation plan as well as to provide the necessary capital to pursue future growth initiatives while strengthening its statement of financial position as the world economy enters a period of uncertainty.

On July 7, 2020, the Company agreed to the sale of its Montreal plant on MacArthur Street in Saint-Laurent, Quebec, which will be effective on October 31, 2020. The closing of the plant was planned as part of the V20 reconfiguration of the Company's North American manufacturing footprint. Gross proceeds will be $12,566 and are conditional upon the submission of a clean Bill 72 environmental report to the Quebec authorities.

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