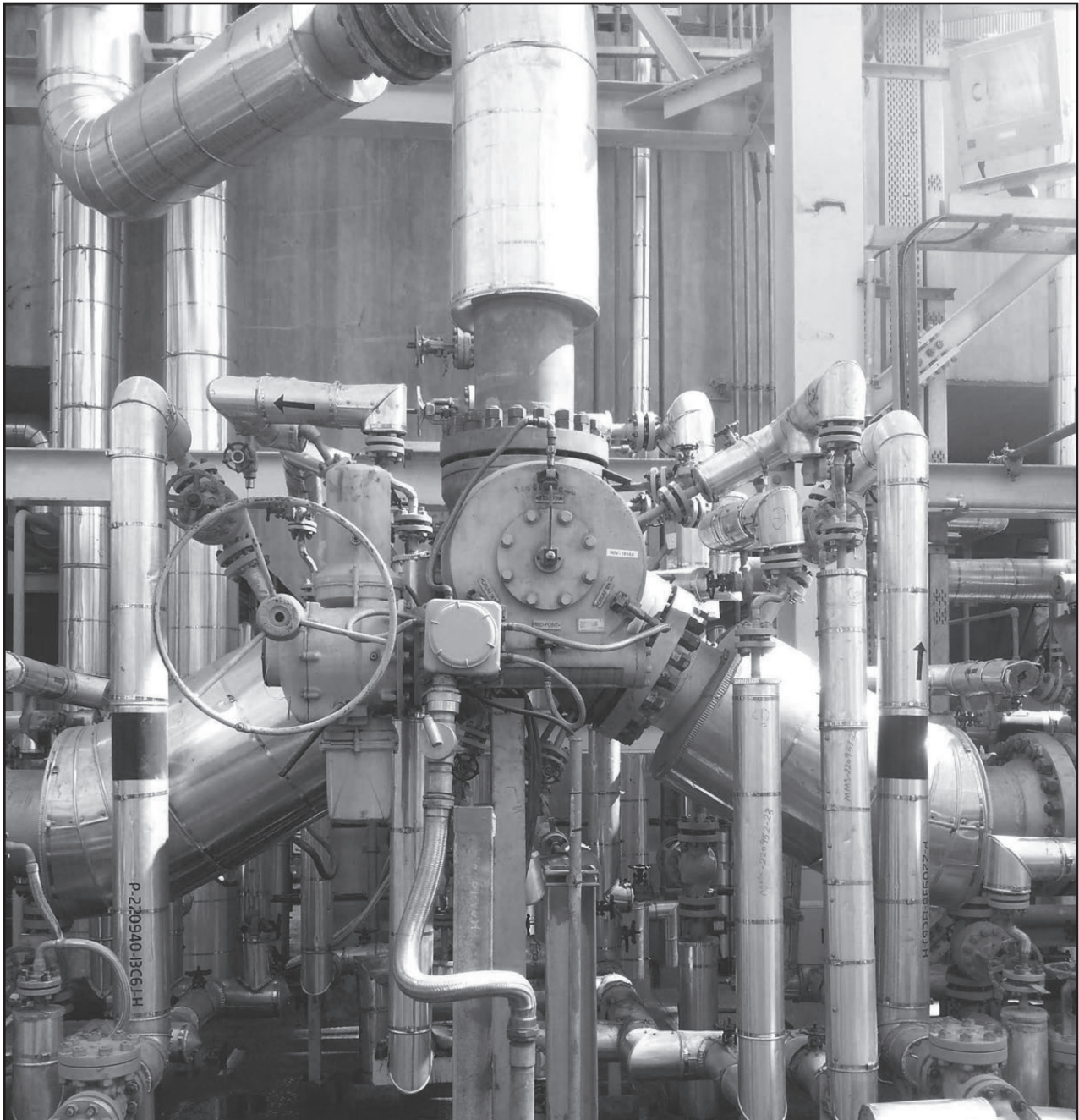


Report to shareholders

Second quarter

Six month period ended August 31, 2020



Velan. Quality that lasts.

VELAN

Management's Discussion and Analysis

2nd QUARTER ENDED AUGUST 31, 2020

October 8, 2020

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, 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 second 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 12 manufacturing plants worldwide with 1,680 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, 2020	Three-month period ended August 31, 2019	Increase (decrease)	% Increase (decrease)
Consolidated statements of earnings				
Sales	\$68.3	\$85.5	\$(17.2)	(20.1)%
Gross profit	17.1	22.0	(4.9)	(22.3)%
Gross profit %	25.0%	25.7%		
Net earnings (loss) ²	(5.1)	1.4	(6.5)	(464.3)%
Net earnings (loss) ² %	(7.5)%	1.6%		
Net earnings (loss) ² per share – basic and diluted	(0.24)	0.06	(0.30)	(500.0)%
Operating profit (loss) before restructuring and transformation costs ³	(4.0)	2.6	(6.6)	(253.8)%
Adjusted EBITDA ³	(0.8)	5.8	(6.6)	(113.8)%
Adjusted EBITDA ³ %	(1.2)%	6.8%		
Adjusted EBITDA ³ per share – basic and diluted	(0.04)	0.27	(0.31)	(114.8)%
Weighted average shares outstanding	21.6	21.6		
Consolidated statements of cash flows				
Cash provided (used) by operating activities	(0.1)	1.2	(1.3)	(108.3)%
Cash used by investing activities	(0.5)	(4.0)	(3.5)	(87.5)%
Cash provided (used) by financing activities	12.2	(0.8)	13.0	(1,625.0)%
Demand data				
Net new orders received	101.3	90.7	10.6	11.7%
Period end backlog of orders	462.7	425.6	37.1	8.7%

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

² Net earnings or loss refers 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

(millions, excluding per share amounts)	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019	Increase (decrease)	% Increase (decrease)
Consolidated statements of earnings				
Sales	\$145.0	\$169.3	\$(24.3)	(14.4)%
Gross profit	35.4	38.1	(2.7)	(7.1)%
Gross profit %	24.4%	22.5%		
Net loss ¹	(7.0)	(4.5)	2.5	55.6%
Net loss ¹ %	(4.8)%	(2.7)%		
Net loss ¹ per share – basic and diluted	(0.32)	(0.21)	0.11	52.4%
Operating loss before restructuring and transformation costs ²	(3.3)	(4.2)	(0.9)	(21.4)%
Adjusted EBITDA ²	3.0	2.0	1.0	50.0%
Adjusted EBITDA ² %	2.1%	1.2%		
Adjusted EBITDA ² per share – basic and diluted	0.14	0.09	0.05	55.6%
Weighted average shares outstanding	21.6	21.6		
Consolidated statements of cash flows				
Cash provided by operating activities	19.1	3.0	16.1	536.7%
Cash used by investing activities	(4.4)	(4.8)	(0.4)	8.3%
Cash provided (used) by financing activities	9.5	(2.8)	12.3	439.3%
Demand data				
Net new orders received	178.0	154.9	23.1	14.9%
Period end backlog of orders	462.7	425.6	37.1	8.7%

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

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, 2020

- Net new orders received ("bookings") amounted to \$101.3 million, an increase of \$24.6 million or 32.1% compared to the first quarter of the current fiscal year and \$10.6 million or 11.7% compared to last year. This increase is primarily attributable to higher orders recorded by the Company's French and North American operations, particularly in the nuclear and downstream oil and gas industries.
- Sales amounted to \$68.3 million, a decrease of \$17.2 million or 20.1% from the prior year. Sales were negatively impacted by reduced shipments primarily attributable to supply chain issues created by the novel coronavirus ("COVID-19") pandemic as well as inefficiencies experienced in reconfiguring the Canadian plants under the V20 program which caused production delays. The decrease in sales for the quarter is also due to the reduction of non-project orders delivered by the Company's North American operations due to the unfavorable market conditions triggered by the COVID-19 pandemic which significantly affected the Company's distribution channel.
- Gross profit percentage decreased by 70 basis points from 25.7% to 25.0%. The decrease in the gross profit percentage is mainly attributable to the aforementioned lower sales volume that was insufficient to allow the Company to cover its fixed costs efficiently. Furthermore, the Company's gross profit percentage was negatively impacted by a \$1.0 million unfavorable movement in unrealized foreign exchange losses primarily attributable to the weakening of the U.S. dollar against the euro and the Canadian dollar over the course of the quarter. The decrease in gross profit percentage for the quarter was partially offset by the Company's recording of \$2.3 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 wage relief to companies negatively impacted by the market distress caused by the virus.
- Other expenses amounted to \$1.4 million, an increase of \$1.4 million or 100.0% compared to last year. The increase in other expenses is due to land clean-up costs of a former factory. These costs are unrelated to the upcoming sale of the Montreal plant on MacArthur street.
- Net loss¹ amounted to \$5.1 million or \$0.24 per share compared to net earnings¹ of \$1.4 million or \$0.06 per share last year. The increase in net loss¹ for the quarter is primarily attributable to a lower gross profit, a \$1.7 million unfavorable movement in unrealized foreign exchange losses, an increase in other expenses as well as an increase in restructuring and transformation costs, partially offset by the Company's recording of \$4.3 million of wage subsidies which were allocated between cost of sales, administration expenses and restructuring and transformation costs.
- Operating loss before restructuring and transformation costs² amounted to \$4.0 million compared to an operating profit of \$2.6 million last year. Adjusted EBITDA² amounted to a negative \$0.8 million or \$0.04 per share compared to a positive \$5.8 million or \$0.27 per share last year. The decrease in operating profit before restructuring and transformation costs² and adjusted EBITDA² is primarily attributable to a lower gross profit, an increase in unrealized foreign exchange losses as well as an increase in other expenses, partially offset by the Company's recording of wage subsidies.
- During the quarter, the Company agreed to the sale of its Montreal plant on MacArthur Street, which will be effective 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 \$13.3 million and all underlying conditions to the sale were satisfied.

Results for the six-month period ended August 31, 2020

- Bookings amounted to \$178.0 million, an increase of \$23.1 million or 14.9% compared to last year. This increase is primarily attributable to large project orders booked in the Company's North American and French operations, notably in the process, nuclear and downstream oil and gas markets. This increase was partially offset by a decrease in non-project orders booked in the Company's North American operations.
- The Company ended the period with a backlog of \$462.7 million, an increase of \$55.9 million or 13.7% since the beginning of the current fiscal year. In addition to the positive book-to-bill ratio, the backlog was positively impacted by the strengthening of the euro spot rate against the U.S. dollar over the course of the period. The backlog also increased for the period due to the delays in shipments created by the impact the COVID-19 pandemic and the reconfiguration of

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

the Canadian plants under the V20 program has had on the Company's operations. 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.

- The Company ended the period with net cash of \$60.4 million, an increase of \$29.4 million or 94.8% since the beginning of the year. This increase is primarily attributable to positive non-cash working capital movements, particularly in accounts receivables, and an increase in long-term debt, partially offset by investments in property, plant and equipment, long-term debt repayments and V20 related disbursements. Net cash was positively impacted by the strengthening of the euro spot rate against the U.S. dollar over the course of the period.
- Sales amounted to \$145.0 million, a decrease of \$24.3 million or 14.4% from the prior year. The decreased sales volume for the period is attributable to the negative impact that the COVID-19 pandemic had on the global economy as well as the production delays caused by the inefficiencies experienced while reconfiguring the Canadian plants under the V20 program. The decrease in sales for the half year period is also due to lower non-project valve sales caused by the negative impact the global pandemic has had on the Company's distribution channel.
- Gross profit percentage increased by 190 basis points from 22.5% to 24.4%. Despite the lower sales volume, the increase in gross profit percentage is primarily 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. In addition, project manufacturing margins in the Company's North American operations have substantially improved in the last year, the consequence of the Company's sustained efforts to target profitable segments initiated under the V20 transformation program. These efforts, highlighted in previous quarterly reports, are bearing fruits and bringing sustainable margin improvements to the Company's project business, while successfully growing the Company's project backlog. The increase is also attributable to the Company's recording of \$4.2 million of wage subsidies. This increase was partially offset by a \$1.8 million unfavorable movement in unrealized foreign exchange losses primarily attributable to the weakening of the U.S. dollar against the euro and Canadian dollar over the course of the period combined with a lower gross profit percentage in the Company's French operations due to the shipment of a less profitable product mix for the period.
- Administration costs amounted to \$37.4 million, a decrease of \$5.0 million or 11.8% compared to last year. The decrease is primarily attributable to the on-going effort to reduce administration overhead expenses under the V20 plan, a \$3.4 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 travel restrictions and social distancing measures that were enforced in a majority of countries over the course of the period. Furthermore, in an effort to avoid layoffs and protect its talent in the current pandemic context, the Company's North American operations have implemented a temporary salary reduction program from staff employees to board members over the course of the quarter. The decrease in administration costs was partially offset by a \$1.9 million increase in the costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section). The fluctuation in asbestos costs for the period is due more to the timing of settlements in these two periods rather than to changes in long-term trends.
- Net loss¹ amounted to \$7.0 million or \$0.32 per share compared to \$4.5 million or \$0.21 per share last year. The increase in net loss¹ for the half year is primarily attributable to a \$2.6 million unfavorable movement in unrealized foreign exchange losses, the Company's lower gross profit, the increase in other expenses and restructuring and transformation costs combined with an unfavorable movement in income taxes (see *Results of operations* section), partially offset by a reduction in administration costs as well as the Company's recording of \$7.9 million of wage subsidies which were allocated between cost of sales, administration expenses and restructuring and transformation costs.
- Operating loss before restructuring and transformation costs² amounted to \$3.3 million compared to \$4.2 million last year. Adjusted EBITDA² amounted to \$3.0 million or \$0.14 per share compared to \$2.0 million or \$0.09 per share last year. The improvement in operating loss before restructuring and transformation costs² and adjusted EBITDA² is primarily attributable to lowered administration costs, improved margins and the Company's recording of wage subsidies, partially offset by an increase in unrealized foreign exchange losses, higher other expenses and a lower gross profit.

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

➤ Foreign currency impacts:

- Based on spot exchange rates, the euro strengthened by 8.8% against the U.S. dollar when compared to the rate at the end of the last fiscal year. This strengthening resulted in the previously mentioned unrealized currency losses on the conversion of monetary assets and liabilities by the Company's European subsidiaries. Furthermore, the euro strengthening also resulted in a positive cumulative translation adjustment which was recorded directly in equity through other comprehensive income. Based on average exchange rates, the euro remained relatively stable 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 similar U.S. dollar amounts in the current period.
- Based on spot exchange rates, the Canadian dollar strengthened by 3.0% against the U.S. dollar when compared to the rate at the end of the last fiscal year. This strengthening resulted in the previously mentioned unrealized currency losses on the conversion of monetary assets and liabilities by the Company's North American subsidiary. Based on average exchange rates, the Canadian dollar weakened 3.0% 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 period.
- The net impact of the above currency swings was generally unfavourable on the Company's net loss, although it was generally favourable on the Company's equity.

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 2020	May 2020	February 2020	November 2019	August 2019	May 2019	February 2019	November 2018
Sales	\$68,340	\$76,653	\$113,641	\$88,701	\$85,467	\$83,816	\$105,345	\$92,271
Net earnings (loss) ¹	(5,112)	(1,886)	(11,116)	(819)	1,369	(5,824)	1,519	(236)
Net earnings (loss) ¹ per share								
- Basic and diluted	(0.24)	(0.09)	(0.51)	(0.04)	0.06	(0.27)	0.07	(0.01)

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 quarter ended in February 2020 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 quarters ended in May 2020 and August 2020 primarily due to the many disruptions caused by the COVID-19 pandemic. 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 quarter ended August 2019 was due to a more profitable product mix. The net loss¹ for the quarter ended in November 2018 was 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 loss¹ 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 loss¹ for the quarters ended in May 2020 and August 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. The net loss¹ for the quarter ended in August 2020 was also negatively impacted by land clean-up costs of a former factory.

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

Management's Discussion and Analysis

RESULTS OF OPERATIONS – comparison of three and six-month periods ended August 31, 2020 and 2019 *(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, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Sales	\$68.3	\$85.5	\$145.0	\$169.3

Sales decreased by \$17.2 million or 20.1% for the quarter and by \$24.3 million or 14.4% for the half year. The decrease for both periods is primarily attributable to reduced shipments caused by supply chain issues created by the COVID-19 pandemic as well as inefficiencies experienced in reconfiguring the Canadian plants under the V20 program which caused production delays. 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. The decrease in sales for the quarter and half year is also due to lower non-project valve sales caused by the negative impact the global pandemic has had on the Company's distribution channel.

Net bookings and backlog

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Net bookings	\$101.3	\$90.7	\$178.0	\$154.9

Bookings increased by \$10.6 million or 11.7% for the quarter and \$23.1 million or 14.9% for the half year. Bookings increased by \$24.6 million or 32.1% compared to the first quarter of the current fiscal year. The increase for all periods is due to higher large project orders booked by the Company's French and North American operations, particularly in the nuclear and downstream oil and gas industries. The increase for the half year was also obtained due to process project orders recorded by the Company's North American operations. This increase for both periods 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 distribution channel.

(millions)	August 2020	February 2020	August 2019
Backlog	\$462.7	\$406.8	\$425.6
For delivery within the next twelve months	\$289.4	\$257.5	\$284.2
For delivery beyond the next twelve months	\$173.3	\$149.3	\$141.4
Percentage – beyond the next twelve months	37.5%	36.7%	33.2%

As a result of bookings outpacing sales in the half year, the Company's book-to-bill ratio was 1.23 for the period. Furthermore, the total backlog increased by \$55.9 million or 13.7% since the beginning of the fiscal year, settling at \$462.7 million. The backlog was positively impacted by the higher book-to-bill ratio and the strengthening of the euro spot rate against the U.S. dollar over the course of both periods. The backlog also increased for the period due to the delays in shipments created by the impact the COVID-19 pandemic and the reconfiguration of the Canadian plants under the V20 program has had on the Company's operations.

Management's Discussion and Analysis

Gross profit

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Gross profit	\$17.1	\$22.0	\$35.4	\$38.1
Gross profit percentage	25.0%	25.7%	24.4%	22.5%

Gross profit decreased by \$4.9 million for the quarter and \$2.7 million for the half year. The gross profit percentage decreased by 70 basis points for the quarter and increased by 190 basis points for the half year. The gross profit percentage in both periods was negatively impacted by the lower sales volume delivered by the Company as well as unfavorable movements in unrealized foreign exchange losses of \$1.0 million for the quarter and \$1.8 million for the half year primarily attributable to the weakening of the U.S. dollar against the euro and Canadian dollar over the course of both periods. Despite the lower sales volume for both periods, the gross profit percentage was positively impacted by the Company's recording of wage subsidies of \$2.3 million for the quarter and \$4.2 million for the half year. The subsidies were put in place by government authorities to prevent further job losses in the context of the COVID-19 pandemic by offering wage relief to companies negatively impacted by the market distress caused by the virus. In addition, project manufacturing margins in the Company's North American operations have substantially improved in the last year, the consequence of the Company's sustained efforts to target profitable segments initiated under the V20 transformation program. These efforts, highlighted in previous quarterly reports, are bearing fruits and bringing sustainable margin improvements to the Company's project business, while successfully growing the Company's project backlog. The resulting improved product mix, as well as labour and overhead savings stemming from the Company's restructuring and transformation initiatives under V20, started in the prior fiscal year, explain why the half year period gross profit percentage has improved.

Administration Costs

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Administration costs*	\$19.7	\$19.4	\$37.4	\$42.4
As a percentage of sales	28.8%	22.7%	25.8%	25.0%
*Includes asbestos-related costs of:	\$3.2	\$1.3	\$5.2	\$3.3

Administration costs increased by \$0.3 million or 1.5% for the quarter and decreased by \$5.0 million or 11.8% for the half year. Administration costs for the quarter were negatively impacted by a \$1.9 million increase in the costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section), which was offset by the \$1.9 million reduction of administration employee salaries provided by the Company's recording of wage subsidies. In an effort to avoid layoffs and protect its talent in the current pandemic context, the Company's North American operations have implemented a temporary salary reduction program from staff employees to board members over the course of the quarter. The decrease for the half year is primarily attributable to the on-going effort to reduce administration overhead expenses under the V20 plan, a \$3.4 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 travel restrictions and social distancing measures that were enforced in a majority of countries over the course of the half year. The decrease in administration costs for the half year was partially offset by a \$1.9 million increase in the costs recognized in connection with the Company's ongoing asbestos litigation. The fluctuation in asbestos costs for the period is due more to the timing of settlements in these two periods rather than to changes in long-term trends.

Management's Discussion and Analysis

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 encapsulated entirely within the product in such a way that it would not allow for release of any asbestos in ambient air 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.

Other expense (income)

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Other expense (income)	\$1.4	\$-	\$1.4	\$(0.1)

Other expense increased by \$1.4 million for the quarter and \$1.5 million the half year. The increase in other expenses for both periods is due to land clean-up costs of a former factory. These costs are unrelated to the upcoming sale of the Montreal plant on MacArthur street.

Income taxes

(in thousands, excluding percentages)

	Three-month period ended August 31, 2020		Three-month period ended August 31, 2019	
	\$	%	\$	%
Income tax at statutory rate of 26.6% (August 31, 2019 – 26.7%)	(1,536)	26.6	579	26.7
<u>Tax effects of:</u>				
Difference in statutory tax rates in foreign jurisdictions	51	(0.9)	404	18.6
Non-deductible (taxable) foreign exchange loss (gain)	(143)	2.5	93	4.3
Losses not tax effected (Losses utilized not previously tax effected)	1,079	(18.7)	(99)	(4.6)
Benefit attributable to a financing structure	(64)	1.1	(222)	(10.2)
Other permanent differences	108	(1.8)	96	4.4
Provision for (recovery of) income taxes	(505)	(8.8)	851	39.3

(in thousands, excluding percentages)

	Six-month period ended August 31, 2020		Six-month period ended August 31, 2019	
	\$	%	\$	%
Income tax at statutory rate of 26.6% (August 31, 2019 – 26.7%)	(1,746)	26.6	(1,459)	26.7
<u>Tax effects of:</u>				
Difference in statutory tax rates in foreign jurisdictions	136	(2.1)	366	(6.7)
Non-deductible (taxable) foreign exchange loss (gain)	(12)	0.2	422	(7.7)
Losses not tax effected (Losses utilized not previously tax effected)	2,301	(35.1)	(48)	0.9
Benefit attributable to a financing structure	(125)	1.9	(444)	8.1
Other permanent differences	54	(0.8)	195	(3.6)
Provision for (recovery of) income taxes	608	(9.3)	(968)	17.7

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 earnings (loss)¹, Operating profit (loss) before restructuring and transformation costs² and Adjusted EBITDA²

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Net earnings (loss) ¹	\$(5.1)	\$1.4	\$(7.0)	\$(4.5)
As a percentage of sales	(7.5)%	1,6%	(4.8)%	(2.7)%
Operating profit (loss) before restructuring and transformation costs ²	\$(4.0)	\$2.6	\$(3.3)	\$(4.2)
Adjusted EBITDA ²	\$(0.8)	\$5.8	\$3.0	\$2.0
As a percentage of sales	(1.2)%	6.8%	2.1%	1.2%

Net loss¹ for the quarter amounted to \$5.1 million or \$0.24 per share compared to net earnings of \$1.4 million or \$0.06 per share last year. The increase in net loss¹ for the quarter is primarily attributable to a \$1.7 million unfavorable movement in unrealized foreign exchange losses, a lower gross profit, an increase in other expenses as well as an increase in restructuring and transformation costs, partially offset by the Company's recording of \$4.3 million of wage subsidies which were allocated between cost of sales, administration costs and restructuring and transformation costs. Operating loss before restructuring and transformation costs² for the quarter amounted to \$4.0 million compared to an operating profit of \$2.6 million last year. Adjusted EBITDA² for the quarter amounted to a negative \$0.8 million or \$0.04 per share compared to a positive \$5.8 million or \$0.27 per share last year. The decrease in operating profit before restructuring and transformation costs² and adjusted EBITDA² is primarily attributable to an increase in unrealized foreign exchange losses, a lower gross profit as well as an increase in other expenses. Net loss¹ for the half year amounted to \$7.0 million or \$0.32 per share compared to \$4.5 million or \$0.21 per share last year. The increase in net loss¹ for the half year is primarily attributable to a \$2.6 million unfavorable movement in unrealized foreign exchange losses, a lower gross profit, an increase in other expenses and restructuring and transformation costs combined with an unfavorable movement in income taxes, partially offset by a reduction in administration costs as well as the Company's recording of \$7.9 million of wage subsidies which were allocated between cost of sales, administration expenses and restructuring and transformation costs. Operating loss before restructuring and transformation costs² for the half year amounted to \$3.3 million compared to \$4.2 million last year. Adjusted EBITDA² for the half year amounted to \$3.0 million or \$0.14 per share compared to \$2.0 million or \$0.09 per share last year. The improvement in operating loss before restructuring and transformation costs² and adjusted EBITDA² is primarily attributable to lowered administration costs, improved margins and the Company's recording of wage subsidies, partially offset by an increase in unrealized foreign exchange losses, higher other expenses and a lower gross profit.

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:

	As at August 31, 2020					Total \$
	Carrying value \$	Less than 1 year \$	1 to 3 Years \$	4 to 5 Years \$	After 5 years \$	
Long-term debt	33,101	8,497	9,866	6,611	11,800	36,774
Long-term lease Liabilities	15,753	1,972	2,964	2,299	13,840	21,075
Accounts payable and accrued liabilities	75,271	75,270	-	-	-	75,270
Customer deposits	57,085	57,085	-	-	-	57,085
Bank indebtedness and short-term bank loans	26,531	26,531	-	-	-	26,531
Derivative liabilities	730	730	-	-	-	730

On August 31, 2020, the Company's order backlog was \$462.7 million and its net cash plus unused credit facilities amounted to \$138.7 million, which it believes, along with future cash flows generated from operations, is sufficient to meet its financial obligations, increase its capacity of liquidity, 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.

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

The Company secured over the course of the quarter new financing in the form of a \$17.3 million secured mortgage loan and a \$65.0 million 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 faces 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.

Management's Discussion and Analysis

Cash flows - comparison of three and six-month periods ended August 31, 2020 and 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)	August 31, 2020	May 31, 2020	February 29, 2020	August 31, 2019	May 31, 2019
Net cash	\$60.4	\$44.6	\$31.0	\$34.9	\$39.4

The Company's net cash increased by \$15.8 million or 35.4% since the beginning of the current quarter and by \$29.4 million or 94.8% since the beginning of the current fiscal year. The increase for both periods is primarily attributable to an increase in long-term debt, partially offset by investments in property, plant and equipment, long-term debt repayments and V20 related disbursements. The increase since the beginning of the fiscal year is also attributable to cash provided by operating activities. Net cash was positively impacted by the strengthening of the euro spot rate against the U.S. dollar over the course of the quarter and the half year.

Cash provided (used) by operating activities

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Net cash provided (used) by operating activities	\$(0.1)	\$1.2	\$19.1	\$3.0

Cash used by operating activities amounted to \$0.1 million for the current quarter compared to cash provided by operating activities of \$1.2 million in the prior year. The current quarter's source of funds consisted of net loss¹ of \$4.6 million when adjusted for non-cash items and positive non-cash working capital movements of \$4.5 million. The non-cash working capital increase for the quarter resulted from the increase in accounts payable and decrease in accounts receivable partially offset by the increase in inventories. Cash provided by operating activities amounted to \$19.1 million for the current half year period compared to \$3.0 million in the prior year. The current half year's source of funds consisted of net loss¹ of \$1.9 million when adjusted for non-cash items and positive non-cash working capital movements of \$21.0 million, which was primarily the result of a decrease in accounts receivables.

Accounts receivable

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Accounts receivable decrease	\$6.3	\$2.6	\$24.9	\$17.2

Accounts receivable balances are a function of the timing of sales and cash collections. The accounts receivable balance decreased since the beginning of the fiscal year due to a combination of lower sales output in both the quarter and the half year, coupled with increased collections of prior year accounts in the first quarter of the current 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

Inventories

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Inventory increase	\$9.8	\$5.1	\$4.8	\$11.0
Customer deposits increase	\$3.2	\$3.9	\$6.5	\$2.8

Inventories typically increase in times of rising backlog and order bookings and decrease when the opposite occurs. Inventories are also a function of timing between receipts and shipments. For the current quarter and half year, inventories increased as a result of the increase in the Company's backlog. In order to help finance its investment in inventories, the Company, where possible, obtains customer deposits for large orders. Customer deposits increased due to higher customer deposits on certain large export project orders in the Company's Italian and North American operations for the quarter and French, Italian and North American operations for the half year.

Accounts payable and accrued liabilities

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Accounts payable and accrued liabilities increase (decrease)	\$8.4	\$(10.5)	\$(2.0)	\$(9.0)

The increase 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, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Additions to property, plant and equipment	\$1.4	\$1.0	\$3.9	\$1.7
Proceeds on disposal of property, plant and equipment	\$1.0	\$-	\$1.0	\$-

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

During the quarter, the Company used the service of an auctioneer to dispose of some excess machinery and equipment that will not be required once the upcoming sale of its Montreal plant on MacArthur street, is completed on October 31, 2020.

Management's Discussion and Analysis

Dividends paid

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Dividends paid	\$-	\$0.5	\$0.5	\$1.0

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

(millions)	Three-month period ended August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Additions to long-term debt	\$14.3	\$1.1	\$14.3	\$1.1
Repayment of long-term debt	\$1.3	\$1.1	\$2.1	\$1.9

During the course of the quarter, while the Company continued to pay down its outstanding long-term debt, its North American operations borrowed \$10.9 million in the form of a secured mortgage loan bearing monthly interest payments of 3.80%, with principal payments beginning in October 2021 and repayable over 20 years. Additionally, its Italian subsidiary secured three new long-term debt issuances with two financial institutions as part of the measures and initiatives put in place by the Italian government to support companies in the current pandemic context. Specifically, the subsidiary borrowed \$3.4 million in the form of unsecured state bank loans, bearing interest between 1.00% and 1.25%, with principal repayments beginning in 2021 and 2022 and repayable in monthly and quarterly installments, expiring in 2025 and 2026.

Management's Discussion and Analysis

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
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.

Management's Discussion and Analysis

The amounts outstanding as at August 31, 2020 and February 29, 2020 are as follows:

	Range of exchange rates		Gain (loss)		Notional amount	
	August 31, 2020	February 29, 2020	August 31, 2020 (In thousands of U.S. dollars) \$	February 29, 2020 (In thousands of U.S. dollars) \$	August 31, 2020 (In thousands of indicated currency)	February 29, 2020 (In thousands of indicated currency)
Foreign exchange forward contracts						
Sell US\$ for CA\$ – 0 to 12 months	1.33-1.34	1.33-1.34	(320)	(923)	US\$34,000	US\$68,000
Buy US\$ for CA\$ – 0 to 12 months	1.31-1.33	1.31-1.33	39	357	US\$34,000	US\$68,000
Buy US\$ for € – 0 to 12 months	1.10-1.11	1.10-1.11	(25)	(3)	US\$312	US\$1,205
Sell € for US\$ – 0 to 12 months	1.11-1.14	1.11-1.14	(385)	(174)	€12,240	€16,790
Buy € for US\$ – 0 to 12 months	1.10-1.11	1.10-1.11	-	198	€12,240	€16,790
Sell US\$ for KW – 0 to 12 months	-	1,139-1,171	-	(70)	-	US\$1,647
Total Gain (loss)			(691)	(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 August 31, 2020, four (February 29, 2020 – four) customers accounted for more than 5% each of its trade accounts receivable, of which one customer accounted for 16.6% (February 29, 2020 – 15.0%), and the Company's ten largest customers accounted for 63.0% (February 29, 2020 – 61.2%) of trade receivables. In addition, there was one (August 31, 2019 – one) customer who 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.

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.

Management's Discussion and Analysis

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

(In thousands of U.S. dollars)	August 31, 2020 \$	February 29, 2020 \$
Current	57,526	83,711
Past due 0 to 30 days	15,994	16,619
Past due 31 to 90 days	13,450	7,445
Past due more than 90 days	21,047	21,989
	108,017	129,764
Less: Loss allowance	1,770	2,002
Trade accounts receivable	106,247	127,762
Other receivables	10,758	7,480
Total accounts receivable	117,005	135,242

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

(In thousands of U.S. dollars)	August 31, 2020 \$	August 31, 2019 \$
Balance – Beginning of the year	2,002	1,662
Loss allowance expense	2	189
Recoveries of trade accounts receivable	(122)	-
Write-off of trade accounts receivable	(212)	(28)
Foreign exchange	100	134
Balance – End of the period	1,770	1,957

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. 1,639 claims were outstanding at the end of the reporting period (February 29, 2020 – 1,561). These claims were filed in the states of 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 and West Virginia. During the reporting period, the Company resolved 175 claims (August 31, 2019 – 189) and was the subject of 253 new claims (August 31, 2019 – 322). 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 \$3,171 for the quarter (August 31, 2019 - \$1,315) and \$5,217 (August 31, 2019 - \$3,343) for the six-month period.

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	
	2020	2019	2020	2019
Purchases of material components	\$131	\$191	\$278	\$408

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

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 and six-month periods ended August 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 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.

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 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.

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 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 August 31, 2020	Three-month period ended August 31, 2019	Six-month period ended August 31, 2020	Six-month period ended August 31, 2019
Operating profit (loss)	(5.7)	2.0	(6.2)	(5.3)
<u>Adjustment for:</u>				
Restructuring and transformation costs	1.7	0.6	2.9	1.1
Operating profit (loss) before restructuring and transformation costs	(4.0)	2.6	(3.3)	(4.2)
Net earnings (loss) ¹	(5.1)	1.4	(7.0)	(4.5)
<u>Adjustments for:</u>				
Depreciation of property, plant and equipment	2.5	2.6	5.0	5.2
Amortization of intangible assets	0.6	0.5	1.2	1.0
Finance costs (income) – net	-	(0.2)	0.3	0.1
Provision for (Recovery of) income taxes	(0.5)	0.9	0.6	(0.9)
EBITDA	(2.5)	5.2	0.1	0.9
<u>Adjustment for:</u>				
Restructuring and transformation costs	1.7	0.6	2.9	1.1
Adjusted EBITDA	(0.8)	5.8	3.0	2.0

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 and six-month periods ended August 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 and six-month periods ended August 31, 2020

Velan Inc.

Condensed Interim Consolidated Statements of Financial Position

(Unaudited)

(in thousands of U.S. dollars)

As At	August 31, 2020 \$	February 29, 2020 \$
Assets		
Current assets		
Cash and cash equivalents	86,894	75,327
Short-term investments	1,154	627
Accounts receivable	117,005	135,242
Income taxes recoverable	8,598	8,747
Inventories (note 5)	181,558	170,265
Deposits and prepaid expenses	6,965	5,191
Derivative assets (note 10)	39	555
Assets held for sale (note 6)	2,865	-
	<u>405,078</u>	<u>395,954</u>
Non-current assets		
Property, plant and equipment	95,952	98,179
Intangible assets and goodwill	17,719	17,148
Deferred income taxes	27,937	26,702
Other assets	1,009	513
	<u>142,617</u>	<u>142,542</u>
Total assets	<u>547,695</u>	<u>538,496</u>
Liabilities		
Current liabilities		
Bank indebtedness	26,529	44,317
Short-term bank loans	2	1,379
Accounts payable and accrued liabilities	75,271	74,271
Income taxes payable	1,104	1,493
Customer deposits	57,085	47,208
Provisions	15,155	14,963
Provision for performance guarantees	21,461	21,127
Derivative liabilities (note 10)	730	1,169
Current portion of long-term lease liabilities	1,629	1,621
Current portion of long-term debt (note 7)	7,995	8,311
	<u>206,961</u>	<u>215,859</u>
Non-current liabilities		
Long-term lease liabilities	14,124	13,722
Long-term debt (note 7)	25,106	10,986
Income taxes payable	1,411	1,576
Deferred income taxes	2,879	2,869
Other liabilities	8,715	8,623
	<u>52,235</u>	<u>37,776</u>
Total liabilities	<u>259,196</u>	<u>253,635</u>
Total equity	<u>288,499</u>	<u>284,861</u>
Total liabilities and equity	<u>547,695</u>	<u>538,496</u>
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	
	2020 \$	2019 \$	2020 \$	2019 \$
Sales (note 12)	68,340	85,467	144,993	169,283
Cost of sales (note 5)	51,287	63,485	109,548	131,207
Gross profit	17,053	21,982	35,445	38,076
Administration costs	19,687	19,430	37,354	42,384
Restructuring and transformation costs (note 15)	1,723	565	2,899	1,074
Other expense (income)	1,369	4	1,393	(53)
Operating profit (loss)	(5,726)	1,983	(6,201)	(5,329)
Finance income	298	595	414	735
Finance costs	342	409	776	876
Finance income (costs) – net	(44)	186	(362)	(141)
Income (Loss) before income taxes	(5,770)	2,169	(6,563)	(5,470)
Provision for (Recovery of) income taxes	(505)	851	608	(968)
Net income (loss) for the period	(5,265)	1,318	(7,171)	(4,502)
Net income (loss) attributable to:				
Subordinate Voting Shares and Multiple Voting Shares	(5,112)	1,369	(6,998)	(4,455)
Non-controlling interest	(153)	(51)	(173)	(47)
	(5,265)	1,318	(7,171)	(4,502)
Net income (loss) per Subordinate and Multiple Voting Share				
Basic	(0.24)	0.06	(0.32)	(0.21)
Diluted	(0.24)	0.06	(0.32)	(0.21)
Dividends declared per Subordinate and Multiple Voting Share	- (CA\$ -)	0.02 (CA\$0.03)	- (CA\$-)	0.04 (CA\$0.06)
Total weighted average number of Subordinate and Multiple Voting Shares				
Basic	21,585,635	21,621,935	21,585,635	21,621,935
Diluted	21,585,635	21,621,935	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 Income (Loss)

(Unaudited)

(in thousands of U.S. dollars)

	Three-month periods ended August 31		Six-month periods ended August 31	
	2020	2019	2020	2019
	\$	\$	\$	\$
Comprehensive income (loss)				
Net income (loss) for the period	(5,265)	1,318	(7,171)	(4,502)
Other comprehensive income (loss)				
Foreign currency translation adjustment on foreign operations whose functional currency is other than the reporting currency (U.S. dollar)	9,903	(1,719)	10,809	(4,570)
Comprehensive income (loss)	<u>4,638</u>	<u>(401)</u>	<u>3,638</u>	<u>(9,072)</u>
Comprehensive income (loss) attributable to:				
Subordinate Voting Shares and Multiple Voting Shares	4,707	(316)	3,777	(8,853)
Non-controlling interest	<u>(69)</u>	<u>(85)</u>	<u>(139)</u>	<u>(219)</u>
	<u>4,638</u>	<u>(401)</u>	<u>3,638</u>	<u>(9,072)</u>

Other comprehensive income (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						Non-controlling interest	Total equity
	Number of shares	Share capital (note 8)	Contributed surplus	Accumulated other comprehensive income (loss)	Retained earnings	Total		
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)
Effect of share-based compensation (note 8 (d))	-	-	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 29, 2020	21,585,635	72,695	6,260	(34,047)	236,269	281,177	3,684	284,861
Net loss for the period	-	-	-	-	(6,998)	(6,998)	(173)	(7,171)
Other comprehensive income	-	-	-	10,775	-	10,775	34	10,809
Balance - August 31, 2020	21,585,635	72,695	6,260	(23,272)	229,271	284,954	3,545	288,499

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	
	2020 \$	2019 \$	2020 \$	2019 \$
Cash flows from				
Operating activities				
Net income (loss) for the period	(5,265)	1,318	(7,171)	(4,502)
Adjustments to reconcile net income (loss) to cash provided (used) by operating activities (note 13)	633	4,230	5,259	6,913
Changes in non-cash working capital items (note 14)	4,492	(4,315)	21,015	544
Cash provided (used) by operating activities	(140)	1,233	19,103	2,955
Investing activities				
Short-term investments	610	(1,634)	(527)	(1,638)
Additions to property, plant and equipment	(1,405)	(966)	(3,936)	(1,714)
Additions to intangible assets	(266)	(111)	(523)	(133)
Proceeds on disposal of property, plant and equipment, and intangible assets	989	7	1,029	39
Net change in other assets	(467)	(1,341)	(489)	(1,328)
Cash used by investing activities	(539)	(4,045)	(4,446)	(4,774)
Financing activities				
Dividends paid to Subordinate and Multiple Voting shareholders	-	(486)	(482)	(962)
Short-term bank loans	(395)	(53)	(1,377)	(492)
Increase in long-term debt	14,305	1,122	14,305	1,122
Repayment of long-term debt	(1,299)	(1,143)	(2,058)	(1,859)
Repayment of long-term lease liabilities	(425)	(262)	(856)	(658)
Cash provided (used) by financing activities	12,186	(822)	9,532	(2,849)
Effect of exchange rate differences on cash	4,218	(853)	5,166	(1,288)
Net change in cash during the period	15,725	(4,487)	29,355	(5,956)
Net cash – Beginning of the period	44,640	39,397	31,010	40,866
Net cash – End of the period	60,365	34,910	60,365	34,910
Net cash is composed of:				
Cash and cash equivalents	86,894	78,267	86,894	78,267
Bank indebtedness	(26,529)	(43,357)	(26,529)	(43,357)
	60,365	34,910	60,365	34,910
Supplementary information				
Interest received (paid)	(115)	179	(463)	458
Income taxes received (paid)	(1,954)	1,676	(2,509)	3,507

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, 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 October 8, 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 and six-month periods ended August 31, 2020 have been prepared in accordance with International Financial Reporting Standards (“IFRS”) in accordance with International Accounting Standard (“IAS”) 34, *Interim Financial Reporting*. 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.

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

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

However, the occurrence of the novel coronavirus (“COVID-19”) pandemic has caused disruptions in the Company’s global operations which have materially adversely affected its business and financial results for the three-month and six-month periods ended August 31, 2020. The economic slowdown triggered by the global pandemic has translated in a lower sales volume and subsequently depressed results for the Company while net order bookings have showed positive trends for both periods. While the Company has implemented proactive measures to protect its global workforce and mitigate the numerous effect of the pandemic, given the ongoing dynamic nature of circumstances surrounding COVID-19, it is not possible to reliably estimate the length, severity and long term impact the global pandemic may have on the Company’s results, conditions and cash-flows.

During the six-month period ended August 31, 2020, the company has qualified for wage subsidies which provided a reduction of salaries of \$4,173 in Cost of sales, \$3,434 in Administration costs and \$267 in Restructuring and transformation costs. During the three-month period ended August 31, 2020, the company has qualified for wage subsidies which provided a reduction of salaries of \$2,278 in Cost of sales, \$1,869 in Administration costs and \$123 in Restructuring and transformation costs.

5 Inventories

	August 31, 2020 \$	February 29, 2020 \$
Raw materials	42,933	35,920
Work in process	107,765	95,123
Finished goods	30,860	39,222
	<u>181,558</u>	<u>170,265</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, 2020 of \$2,798 (August 31, 2019 – \$2,853), including reversals of \$2,539 (August 31, 2019 - \$2,007). The Company recognized a net additional inventory provision for the three-month period ended August 31, 2020 of \$2,266 (August 31, 2019 – \$1,651), including reversals of \$1,152 (August 31, 2019 - \$932).

6 Assets held for sale

	August 31, 2020 \$	February 29, 2020 \$
Land	360	-
Building	2,476	-
Machinery & Equipment	29	-
	<u>2,865</u>	<u>-</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)

During the six-month period ended August 31, 2020, the Company agreed to the sale of its Montreal plant on MacArthur Street, which will be effective on October 31, 2020. The plant closure was planned as part of its restructuring and transformation plan (see note 15). Gross proceeds will be \$13,285 and all underlying conditions to the sales have been satisfied. The Company's operations in this particular plant were ceased and transferred within the group during the three-month period ended August 31, 2020. Additionally, the Company's North American operations agreed to use the service of an auctioneer to dispose of some excess machinery and equipment that would not be required in the future. The Company was able to dispose of most of the machinery and equipment over the course of the three-month period ended August 31, 2020.

7 Long-term debt

	August 31, 2020 \$	February 29, 2020 \$
Canadian subsidiary		
Secured bank loan (\$CAD 15,000; February 29, 2020 – nil)	11,248	-
French subsidiaries		
Unsecured bank loan (€3,797; February 29, 2020 – €4,570)	4,533	5,017
Italian subsidiary		
Unsecured bank loan (nil; February 29, 2020 – €330)	-	363
Unsecured state bank loan (€4,035; February 29, 2020 – €1,183)	4,818	1,299
Korean structured entity		
Secured bank loan (KW7,310,620; February 29, 2020 – KW7,757,040)	6,163	6,431
Other	6,339	6,187
	33,101	19,297
Less: Current portion	7,995	8,311
	25,106	10,986

During the course of the quarter ended August 31, 2020, the Company's Canadian subsidiary borrowed \$10,937 in the form of a secured mortgage loan bearing monthly interest payments of 3.80%, with principal repayments beginning in October 2021 and repayable over 20 years. Additionally, its Italian subsidiary borrowed \$3,368 in the form of three unsecured state bank loans, bearing interest between 1.00% and 1.25%, with principal repayments beginning in one to two years and repayable in monthly and quarterly installments, expiring in 2025 and 2026.

On July 17, 2020, the Company secured new financing in the form of a \$65,000 multi-currency revolving credit facility renewable in three years. This revolving credit facility can be drawn in US dollars or Canadian dollars. Drawings bear interest at either the US Base rate, US Prime rate, Canadian prime rate, CDOR or LIBOR, plus a margin based on the Company's excess availability. Under the terms of the credit facility, the Company is required to satisfy a restrictive covenant based on a financial ratio. As at August 31, 2020, the Company has met its covenant.

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

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

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, 2020 \$	February 29, 2020 \$
6,019,068 Subordinate Voting Shares	65,569	65,569
15,566,567 Multiple Voting Shares	7,126	7,126
	<u>72,695</u>	<u>72,695</u>

- 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 and six-month periods ended August 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 six-month period ended August 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 August 31, 2020, the Company had no PSU’s outstanding since they had all expired at the end of the prior fiscal year. As at August 31, 2019, the Company had a total of 24,711 PSUs outstanding, representing a total liability of \$35 which was included in accounts payable and accrued liabilities. For the six-month period ended August 31, 2019, a compensation cost recovery of \$36 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 was recorded in the consolidated statement of income (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 and six-month periods ended 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)

- 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.

Additionally, a grant made to an independent director will be deemed immediately vested.

As at August 31, 2020, the Company had a total of 80,877 (February 29, 2020 – 45,268) DSUs outstanding, representing a total liability of \$149 (February 29, 2020 – \$127) which is included in accounts payable and accrued liabilities. For the six-month period ended August 31, 2020, a compensation cost of \$22 (August 31, 2019 – \$21) was recorded in the consolidated statement of income (loss) and increased accounts payable and accrued liabilities. For the three-month period ended August 31, 2020, a compensation cost of \$39 (August 31, 2019 - \$13) was recorded in the consolidated statement of income (loss) and increased accounts payable and accrued liabilities. During the three-month period ended August 31, 2020, the Company paid 2,072 DSUs for a total of \$9 and granted 37,423 DSUs. No DSUs were forfeited during the six-month periods ended August 31, 2020 and 2019. As at August 31, 2020, 25,793 DSUs (February 29, 2020 – 18,503) were vested.

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, 2020, legal and related costs for these matters amounted to \$5,217 (August 31, 2019 – \$3,343). During the three-month period ended August 31, 2020, legal and related costs for these matters amounted to \$3,171 (August 31, 2019 – \$1,315).

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 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 August 31, 2020				
Financial position classification and nature	Total \$	Level 1 \$	Level 2 \$	Level 3 \$
Assets				
Derivative assets	39	-	39	-
Liabilities				
Derivative liabilities	730	-	730	-

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.

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

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

11 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,	
	2020	2019
	\$	\$
Affiliated company owned by certain relatives of the controlling shareholder		
Purchases – Material components	278	408
Key management ¹ compensation		
Salaries and other short-term benefits	1,924	2,341
Share-based compensation – Options	-	2
Share-based compensation – PSUs and DSUs	22	(15)
	August 31, 2020	February 29, 2020
	\$	\$
Accounts payable and accrued liabilities		
Affiliated companies	100	91

12 Segment reporting

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

	August 31, 2020					
	Canada	United States	France	Italy	Other	Consolidated
	\$	\$	\$	\$	\$	\$
Sales						
Customers -						
Domestic	5,716	45,784	14,861	981	5,736	73,078
Export	21,380	-	17,028	26,106	7,401	71,915
Intercompany (export)	11,368	6,585	64	1	29,509	(47,527)
Total	38,464	52,369	31,953	27,088	42,646	144,993

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

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

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

	August 31, 2019					
	Canada	United States	France	Italy	Other	Consolidated
	\$	\$	\$	\$	\$	Adjustment Consolidated
						\$
Sales						
Customers -						
Domestic	15,713	51,219	18,346	768	10,880	- 96,926
Export	20,198	-	14,343	28,944	8,872	- 72,357
Intercompany (export)	24,971	7,919	42	319	28,529	(61,780) -
Total	60,882	59,138	32,731	30,031	48,281	(61,780) 169,283

13 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,	
	2020	2019	2020	2019
	\$	\$	\$	\$
Depreciation of property, plant and equipment	2,450	2,607	4,975	5,174
Amortization of intangible assets	626	543	1,194	995
Deferred income taxes	(1,492)	707	(856)	858
Share-based compensation expense (note 8 (d))	-	1	-	2
Loss on disposal of property, plant and equipment	22	14	2	33
Net change in derivative assets and liabilities	(1,185)	(220)	77	105
Net change in other liabilities	212	578	(133)	(254)
	633	4,230	5,259	6,913

Velan Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

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

14 Changes in non-cash working capital items

	Three-month periods ended August 31,		Six-month periods ended August 31,	
	2020 \$	2019 \$	2020 \$	2019 \$
Accounts receivable	6,286	2,552	24,866	17,216
Inventories	(9,809)	(5,050)	(4,805)	(10,956)
Income taxes recoverable	(575)	5,720	182	1,733
Deposits and prepaid expenses	(437)	(444)	(1,416)	521
Accounts payable and accrued liabilities	8,365	(10,468)	(1,961)	(8,968)
Income taxes payable	(1,062)	438	(605)	704
Customer deposits	3,225	3,890	6,505	2,783
Provisions	(947)	(208)	(405)	(1,079)
Accrual for performance guarantees	(554)	(745)	(1,346)	(1,410)
	<u>4,492</u>	<u>(4,315)</u>	<u>21,105</u>	<u>544</u>

15 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 (see note 6). 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 six-month period ended August 31, 2020, the Company incurred restructuring and transformation costs of \$2,899 (August 31, 2019 – \$1,074). During the three-month period ended August 31, 2020, the Company incurred restructuring and transformation costs of \$1,723 (August 31, 2019 – \$565). Restructuring and transformation costs consist 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 started the fiscal year with a severance provision of \$4,967 relating to its restructuring and transformation initiative. During the six-month period ended August 31, 2020, The Company paid \$1,660 worth of severance packages and related expenses which brought the provision to \$3,307. All other restructuring and transformation costs are expensed as incurred.

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

Visit us on the Web: <http://www.velan.com>

Velan inc.
7007 chemin de la Côte-de-Liesse,
Montréal, (Québec) H4T 1G2 Canada
Tél : +1 514 748 7743
Télec : +1 514 748 8635