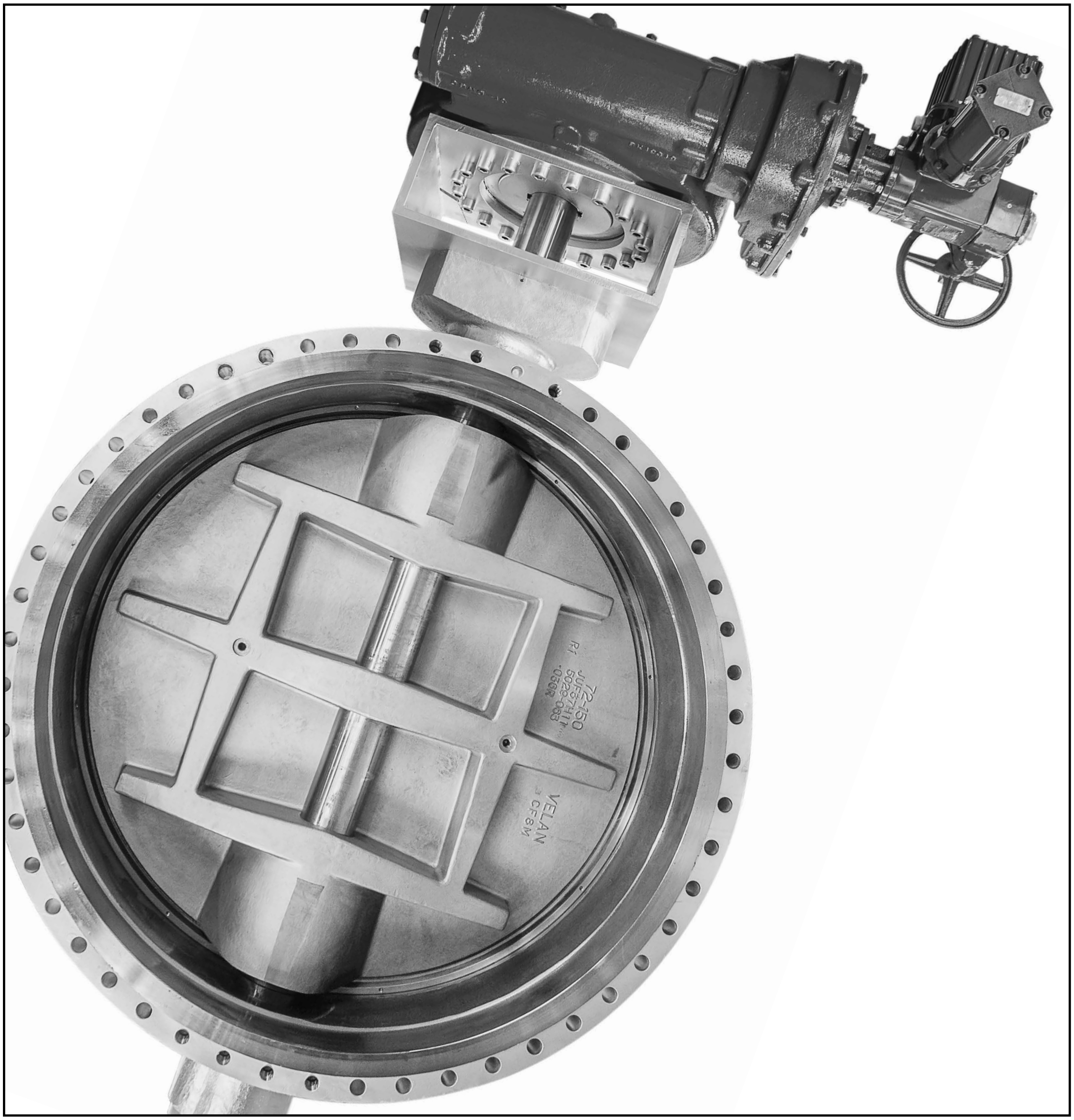
Report to shareholders
First quarter

Three month period ended May 31, 2017



Velan. Quality that lasts.

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Management's Discussion and Analysis

1st QUARTER ENDED MAY 31, 2017

July 13, 2017

The following discussion provides an analysis of the consolidated operating results and financial position of Velan Inc. ("the Company") for the quarter ended May 31, 2017. This Management's Discussion and Analysis ("MD&A") should be read in conjunction with the Company's audited consolidated financial statements for the years ended February 28, 2017 and February 29, 2016. The Company's consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). The significant accounting policies upon which these consolidated financial statements have been prepared are detailed in Note 2 of the Company's audited consolidated financial statements. All foreign currency transactions, balances and overseas operations have been converted to U.S. dollars, the Company's reporting currency. Selected annual information for the three most recently completed reporting periods and a summary of quarterly results for each of the eight most recently completed quarters are included further in this report. Additional information relating to the Company, including the Annual Information Form and Proxy Information Circular, can be found on SEDAR at **www.sedar.com**.

BASIS OF PRESENTATION AND ANALYSIS

The basis of presentation of the Company's first quarter unaudited condensed consolidated financial statements is detailed in Note 1 of the Company's audited consolidated financial statements for the years ended February 28, 2017 and February 29, 2016.

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 fossil, nuclear & cogeneration power, oil & gas, refining & petrochemicals, chemicals, pulp & paper, subsea, liquefied natural gas & cryogenics, marine, mining, heating, ventilation & air conditioning, and water & wastewater. The Company is a world leader in steel industrial valves operating 14 manufacturing plants worldwide with 1,831 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 distinctive 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 and one distribution facility in Canada, as well as one manufacturing plant and two distribution facilities in the U.S. Significant overseas operations include manufacturing plants in France, Italy, Portugal, Korea, Taiwan, India, and China. The Company's operations also include a distribution facility in Germany and a 50%-owned Korean foundry.

CONSOLIDATED HIGHLIGHTS[1]

(millions, excluding per share amounts)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016	Increase (decrease)	% Increase (decrease)
Consolidated statements of earnings				
Sales	$71.1	$77.4	$(6.3)	(8.1)%
Gross profit	13.5	18.7	(5.2)	(27.6)%
Gross profit %	19.0%	24.1%		
Net earnings (loss)[2]	(4.3)	0.5	(4.8)	(960.0)%
Net earnings (loss)[2] %	(6.0)%	0.6%		
Earnings (Loss) per share – basic and diluted	(0.20)	0.02	(0.22)	(1,100.0)%
Weighted average shares outstanding	21.7	21.7		
Consolidated statements of cash flows				
Cash provided (used) by operating activities	(10.1)	12.9	(23.0)	(178.3)%
Cash provided (used) by investing activities	(2.1)	0.1	(2.2)	(2,200.0)%
Cash provided (used) by financing activities	(2.7)	(3.7)	1.0	27.0%
Demand data				
Net new orders received	72.2	110.0	(37.8)	(34.4)%
Period ending backlog of orders	456.6	368.0	88.6	24.1%

[1] *All dollar amounts in this schedule are denominated in U.S. dollars.*
[2] *Net earnings or loss refer to net income or loss attributable to Subordinate and Multiple Voting Shares.*

Management's Discussion and Analysis

Highlights for the three-month period ended May 31, 2017

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

- Net loss[1] amounted to $4.3 million or $0.20 per share compared to net earnings[1] of $0.5 million or $0.02 per share last year. The $4.8 million increase in net loss[1] is primarily attributable to a lower sales volume, a lower gross profit percentage and increased costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section).
- In response to the disappointing results and the current business environment, the Company has accelerated the assessment of its global manufacturing footprint, supply chain and cost structure as per its Velocity 2020 strategic plan. Consequently, the Company has begun a global cost reduction and efficiency initiative with the goal of reducing annual supply chain, production and overhead costs by approximately $20 million by the end of the fiscal year ended February 29, 2020.
- Sales amounted to $71.1 million, a decrease of $6.3 million or 8.1% from the prior year. Sales were negatively impacted by the lack of shippable backlog, particularly in the Company's North American operations, and delays in shipments of certain large project orders caused by various customer-related, supply chain and internal operational issues. Sales were also negatively impacted by lower shipments of non-project commodity valves due to fierce competition and continued weakness in the oil and gas sector, thus increasing the importance for the Company to target discrete market segments where its engineering know-how and agile design capabilities can be a leverage for future growth.
- Net new orders received ("bookings") amounted to $72.2 million, a decrease of $37.8 million or 34.4% compared to last year. This decrease is due primarily to lower project orders booked by the Company's French and Italian subsidiaries, both of which had recorded significant large project orders in the prior year quarter.
- The Company ended the period with a backlog of $456.6 million, an increase of $18.4 million or 4.2% since the beginning of the current fiscal year. While bookings were marginally higher than shipments in the quarter, the increase in backlog is due primarily to the strengthening of the euro spot rate against the U.S. dollar over the course of the current quarter.
- Gross profit percentage decreased by 510 basis points from 24.1% to 19.0%. The decrease in the gross profit percentage is mainly attributable to the lower sales volume as well as a product mix with a lower proportion of higher margin product sales, such as spare parts.
- Administration costs amounted to $19.1 million, an increase of $0.3 million or 1.6%. The increase is due to an increase in costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section), which was partially offset by lower sales commissions. The fluctuation in asbestos costs for the quarter is due more to the timing of settlement payments in these two periods rather than to changes in long-term trends.
- The Company ended the quarter with net cash[2] of $61.6 million, a decrease of $10.9 million or 15.0% since the beginning of the current fiscal year. This decrease is primarily attributable to negative non-cash working capital movements, particularly an increase in inventories and accounts receivable, partially offset by an increase in customer deposits.
- Foreign currency impacts:
    - Based on average exchange rates, the Euro weakened 3.9% against the U.S. dollar when compared to the same period last year. This weakening resulted in the Company's net profits and bookings from its European subsidiaries being reported as lower U.S. dollar amounts in the current quarter.
    - Based on average exchange rates, the Canadian dollar weakened 3.6% against the U.S. dollar when compared to the same period last year. This weakening resulted in the Company's Canadian dollar expenses being reported as lower U.S. dollar amounts in the current quarter.
    - The net impact of the above currency swings was not significant on the Company's net earnings[1].

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

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

SUMMARY OF QUARTERLY RESULTS

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

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

	QUARTERS ENDED							
	May 2017	**February 2017**	**November 2016**	**August 2016**	**May 2016**	**February 2016**	**November 2015**	**August 2015**
Sales	$71,087	$102,835	$80,396	$71,137	$77,409	$108,156	$104,002	$111,558
Net earnings (loss)[1]	(4,304)	3,707	1,501	2,001	528	(7,823)	3,608	4,749
Net earnings (loss)[1] per share								
- Basic	(0.20)	0.17	0.07	0.10	0.02	(0.35)	0.16	0.22
- Diluted	(0.20)	0.17	0.07	0.10	0.02	(0.35)	0.16	0.22

Sales can vary from one quarter to the next due to the timing of the shipment of large project orders. Sales were higher in the quarters ended in August 2015, November 2015, February 2016 and February 2017 due to increased shipments of such orders, while the lower sales amounts for the quarters ended in May 2016, August 2016, November 2016 and May 2017 were due to delayed execution on the shipments of such orders. Net earnings[1] for the quarters ended in August 2015, November 2015 and February 2017 were higher due to a more efficient product mix. A net loss[1] was recorded in the quarter ended February 2016 due to a non-cash goodwill impairment loss, while the net loss[1] recorded in the quarter ended May 2017 was due to lower sales volume and a less efficient product mix. Net earnings[1] for the quarters ended May 2016, August 2016 and November 2016 were lower due to the lower sales volume.

RESULTS OF OPERATIONS – quarter ended May 31, 2017 compared to the quarter ended May 31, 2016 *(unless otherwise noted, all amounts are in U.S. dollars and all comparisons are to the first quarter of the last fiscal year)*

Sales

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Sales	$71.1	$77.4

Sales decreased by $6.3 million or 8.1% for the quarter. Sales were negatively impacted by the lack of shippable backlog, particularly in the Company's North American operations, and delays in shipments of certain large project orders caused by various customer-related, supply chain and internal operational issues. One particular project order destined to an oil and gas project in Mexico, totalling approximately $11 million, has been ready to ship since the first quarter of the prior fiscal year but was delayed due to the customer having put the order on hold. While the customer has maintained its commitment to eventually take possession of these goods, it is currently unclear as to the timing of their shipment. Sales were also negatively impacted by lower shipments of non-project commodity valves, particularly in North America. At first, the weakness in this segment, which mainly sells into the oil and gas sector, was perceived to be temporary and largely related to market conditions. However, as competition has intensified and competitors have gained market share, it is now apparent that the decline is more permanent. As such, it has become imperative for the Company to shift its focus and target discrete market segments where its engineering know-how and agile design capabilities can be a leverage for future growth.

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

Bookings and backlog

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Bookings	$72.2	$110.0

Bookings decreased by $37.8 million or 34.4% for the quarter. This decrease is due primarily to lower project orders booked by the Company's French and Italian subsidiaries, both of which had recorded significant large project orders in the prior year comparative quarter. Furthermore, bookings were negatively impacted by the cancellation of a $6 million oil and gas sector order at the Company's Italian subsidiary. While the Company's North American operations recorded flat bookings for the quarter, such amount remains low when compared to previous fiscal years. The current highly competitive environment in its various markets continues to put downward pressure on pricing and lead times. Given these trends, the Company has accelerated the assessment of its global manufacturing footprint, supply chain and cost structure as per its Velocity 2020 strategic plan. Consequently, the Company has begun a global cost reduction and efficiency initiative with the goal of reducing annual supply chain, production and overhead costs by approximately $20 million by the end of the fiscal year ended February 29, 2020.

(millions)	**May 2017**	**February 2017**	**May 2016**
Backlog	$456.6	$438.2	$368.0
For delivery within the next twelve months	$288.5	$270.5	$277.3
For delivery beyond the next twelve months	$168.1	$167.7	$90.7
Percentage – beyond the next twelve months	36.8%	38.3%	24.7%

While the Company's book-to-bill ratio was a relatively flat 1.02 for the current quarter, the total backlog increased by $18.4 million or 4.2% since the beginning of the fiscal year, settling at $456.6 million. The backlog was positively impacted by the strengthening of the euro spot rate against the U.S. dollar over the course of the current quarter.

Gross profit

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Gross profit	$13.5	$18.7
Gross profit percentage	19.0%	24.1%

Gross profit decreased by $5.2 million or 27.6% for the quarter, while the gross profit percentage decreased by 510 basis points from 24.1% to 19.0%. The decrease in the gross profit percentage is mainly attributable to the lower sales volume as well as a product mix with a lower proportion of higher margin product sales, such as spare parts. With the lower sales volume this quarter than in the previous eight quarters, there was a greater negative impact on the Company's gross profit from the fixed cost component of its cost of sales. This further accentuates the need for the global cost reduction and efficiency initiative described above (See *Bookings and Backlog* subsection above).

Management's Discussion and Analysis

Administration Costs

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Administration Costs*	$19.1	$18.8
As a percentage of sales	26.9%	24.3%
*Includes asbestos-related costs of:	$2.2	$1.4

Administration costs increased by $0.3 million or 1.6%, which was due to a $0.8 million increase in costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section). The fluctuation in asbestos costs for the quarter is due more to the timing of settlement payments in these two periods rather than to changes in long-term trends. Excluding the fluctuation of asbestos related costs, administration costs would have decreased by $0.5 million or 2.9%. This decrease is due primarily to lower sales commission costs resulting from the lower sales volume achieved in the quarter.

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

Finance income (costs)

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Net finance income (costs)	$(0.02)	$0.14

Net finance costs increased by $0.2 million for the quarter. While long-term debt remained relatively stable when compared to the beginning of the quarter, the Company's overall debt load increased, particularly its bank indebtedness in its North American and Italian operations, resulting in an increase in its finance costs (see *Liquidity and Capital Resources* section).

Income taxes

(in thousands, excluding percentages)	Three-month period ended May 31, 2017 $	%	Three-month period ended May 31, 2016 $	%
Income (Loss) before income taxes	(5,968)	100.0	146	100.0
Taxes calculated at domestic tax rates applicable to earnings in the respective countries	(1,620)	27.2	32	30.6
Tax effects of:				
Non-deductible (taxable) foreign exchange loss (gain)	(19)	0.3	(151)	0.6
Losses not tax effected	479	(8.0)	131	0.2
Benefit attributable to a financing structure	(226)	3.8	(252)	(7.2)
Other differences	4	(0.1)	(188)	(4.4)
Provision for (Recovery of) income taxes	(1,382)	23.2	(428)	19.8

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

Net earnings (loss)[1]

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Net earnings (loss)[1]	$(4.3)	$0.5
As a percentage of sales	(6.0)%	0.6%

Net loss[1] amounted to $4.3 million or $0.20 per share compared to net earnings[1] of $0.5 million or $0.02 per share last year. The $4.8 million increase in net loss[1] is primarily attributable to a lower sales volume, a lower gross profit percentage and increased costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section).

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

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

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

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

(In thousands)	May 31, 2017				
	Total $	Less than 1 year $	1 to 3 Years $	4 to 5 Years $	After 5 years $
Long-term debt	22,546	7,410	5,984	4,144	5,008
Accounts payable and accrued liabilities	58,475	58,475	-	-	-
Customer deposits	49,631	49,631	-	-	-
Accrual for performance guarantees	28,549	28,549	-	-	-
Bank indebtedness and short-term bank loans	24,135	24,135	-	-	-
Derivative liabilities	1,859	1,859	-	-	-

On May 31, 2017, the Company's order backlog was $456.6 million and its net cash[1] plus unused credit facilities amounted to $141.9 million, which it believes, along with future cash flows generated from operations, is sufficient to meet its financial obligations, increase its capacity, satisfy its working capital requirements, and execute on its business strategy. However, there can be no assurance that the risk of another sharp downturn in the economy will not materially adversely affect the Company's results of operations or financial condition. The Company continues to closely monitor the continued weakness of the price of oil and the euro currency. The Company is in compliance with all covenants related to its debt and credit facilities.

As a corollary to managing its liquidity risk, the Company also monitors the financial health of its key suppliers.

Proposed transactions

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

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

Cash flows - quarter ended May 31, 2017 compared to the quarter ended May 31, 2016

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

Net cash[1]

(millions)	May 31, 2017	February 28, 2017	May 31, 2016
Net cash[1]	$61.6	$72.5	$93.0

The Company's net cash[1] decreased by $10.9 million or 15.0% during the quarter. This decrease was primarily attributable to negative non-cash working capital movements, particularly an increase in inventories and accounts receivable, partially offset by an increase in customer deposits.

Cash provided (used) by operating activities

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Cash provided (used) by operating activities	$(10.1)	$12.9

Cash used by operating activities amounted to $10.1 million for the current quarter compared to cash provided by operating activities of $12.9 million in the prior year. The current quarter's negative variance consisted of positive cash net earnings[2] of $0.8 million offset by negative non-cash working capital movements of $10.9 million, which consisted primarily of an increase in inventories and accounts receivable, partially offset by an increase in customer deposits.

Accounts receivable

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Accounts receivable decrease (increase)	$(5.1)	$16.1

Accounts receivable balances are a function of the timing of sales and cash collections. The accounts receivable balance increased in the current quarter due primarily to a greater proportion of the Company's accounts receivable consisting of sales for large project orders, which generally entail longer collection terms.

Inventories

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Inventories decrease (increase)	$(8.3)	$(6.0)
Customer deposits increase (decrease)	$5.9	$8.6

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, the inventory increase is primarily due to the Company's French and Italian operations which are building up inventory to coincide with the increase in backlog. In order to help finance its investment in inventories, the Company, where possible, obtains customer

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

deposits for large orders. Customer deposits increased for the current quarter due to higher customer deposits on certain large export project orders in the Company's German operations.

Accounts payable and accrued liabilities

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Accounts payable and accrued liabilities (decrease) increase	$(2.1)	$(1.2)

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

Additions to property, plant and equipment

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Additions to property, plant and equipment	$1.6	$1.3

The increase in additions to property, plant and equipment for the current quarter when compared to the prior year is due to the timing of the receipts of certain equipment.

Dividends

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Dividends paid	$1.6	$1.6

The Company maintained its current dividend policy of CA$0.10 per share per quarter.

Long-term debt

(millions)	Three-month period ended May 31, 2017	Three-month period ended May 31, 2016
Repayment of long-term debt	$0.7	$2.0

During the current quarter, the Company continued to pay down its long-term debt without undertaking any new debt issuances.

FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

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

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

Risk overview

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

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

Market risk

Currency risk

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

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

The amounts outstanding as at May 31, 2017 and February 28, 2017 are as follows:

	Range of exchange rates		Gain (loss) (In thousands of U.S. dollars)		Notional amount (In thousands of indicated currency)	
	May 31, 2017	February 28, 2017	May 31, 2017 $	February 28, 2017 $	May 31, 2017	February 28, 2017
Foreign exchange forward contracts						
Sell US$ for CA$ – 0 to 12 months	1.32-1.34	1.32	(918)	(615)	US$60,000	US$40,000
Buy US$ for CA$ – 0 to 12 months	1.30-1.32	1.30-1.31	52	337	US$60,000	US$40,000
Sell US$ for € – 0 to 12 months	1.16	1.09-1.16	(5)	(20)	US$220	US$336
Buy US$ for € – 0 to 12 months	1.14-1.28	1.06-1.28	37	249	US$3,139	US$4,295
Sell US$ for KW – 0 to 12 months	1,193-1,198	1,193-1,200	74	99	US$1,170	US$1,668
Sell € for US$ – 0 to 12 months	1.08-1.13	1.06-1.08	(899)	(155)	€32,700	€16,122
Buy € for US$ – 0 to 12 months	1.06-1.09	1.06-1.08	87	509	€33,607	€33,600
Buy £ for € – 0 to 12 months	0.84	0.84-0.85	(3)	(1)	£70	£144

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

Cash flow and fair value interest rate risk

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

Credit risk

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

The Company's credit risk related to its trade accounts receivable is concentrated. As at May 31, 2017, four (February 28, 2017 – four) customers accounted for more than 5% each of its trade accounts receivable, of which one customer accounted for 7.6% (February 28, 2017 – 8.5%), and the Company's ten largest customers accounted for 47.2% (February 28, 2017 – 52.4%). In addition, there were no (February 28, 2017 – one) customers that accounted for more than 10% each of the Company's sales.

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

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

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

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

(In thousands of U.S. dollars)	May 31, 2017 $	February 28, 2017 $
Current	76,144	77,262
Past due 0 to 30 days	20,923	19,330
Past due 31 to 90 days	10,038	7,625
Past due more than 90 days	19,755	16,508
	126,860	120,725
Less: Allowance for doubtful accounts	1,316	1,239
Trade accounts receivable	125,544	119,486
Other receivables	5,268	6,026
Total accounts receivable	130,812	125,512

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

(In thousands of U.S. dollars)	May 31, 2017 $	May 31, 2016 $
Balance – Beginning of year	1,239	1,653
Bad debt expenses	-	16
Recoveries of trade accounts receivable	(5)	(252)
Write-off of trade accounts receivable	-	(61)
Foreign exchange	82	29
Balance – End of year	1,316	1,385

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

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

Two of the Company's U.S. subsidiaries have been named as one of the defendants in a number of pending lawsuits that seek to recover damages for personal injury allegedly caused by exposure to asbestos-containing products manufactured and sold in the past. Management believes it has a strong defence related to certain products that may have contained an internal asbestos containing component. 1,151 claims were outstanding at the end of the reporting period (February 28, 2017 – 1,146). These claims were filed in the states of Arkansas, Arizona, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Missouri, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Texas, Virginia, Washington and West Virginia. During the reporting period, the Company resolved 144 claims (May 31, 2016 – 97) and was the subject of 149 new claims (May 31, 2016 – 131). Because of the many uncertainties inherent in predicting the outcome of these proceedings, as well as the course of asbestos litigation in the United States, management believes that it is not possible to make an estimate of the Company's asbestos liability. Accordingly, no provision has been set up in the accounts. Settlement costs and legal fees related to these asbestos claims amounted to $2,208 (May 31, 2016 - $1,399) in the quarter.

On December 3, 2014, San Diego Gas & Electric Company ("SDG") filed a claim against Velan Valve Corp., a wholly-owned subsidiary of the Company, in the Superior Court of the State of California, concerning high pressure valves supplied to SDG and installed at its Palomar Energy Center ("Facility"). This lawsuit alleges damages to the Facility in excess of $9,000 related to allegedly defective valves supplied by Velan Valve Corp. The claim is for alleged strict product liability and alleged negligence. It is the Company's position that this claim is without merit. The Company is vigorously defending its position and is undertaking all actions necessary to protect its reputation. While the Company cannot predict the final outcome of this claim, based on information currently available, the Company believes the resolution of this claim will not have a material adverse effect on its financial position, results of operations or liquidity.

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 Velan's plants.

	Three months ended May 31	
	2017	2016
Purchases of material components	$131	$301

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.

b) One of the Company's subsidiaries and certain of its executives lease, on a weekly basis, a property from Velan Holdings Co. Ltd., the controlling shareholder. Velan Holdings Co. Ltd. charges weekly rates based on usage.

	Three months ended May 31	
	2017	2016
Rent	$12	$18

CONTROLS AND PROCEDURES

The Company did not make any changes to the design of internal controls over financial reporting during the three month period ended May 31, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

CRITICAL ACCOUNTING ESTIMATES & JUDGEMENTS

The Company's financial statements are prepared in accordance with IFRS as issued by the IASB. The Company's significant accounting policies as described in note 2 of the Company's audited consolidated financial statements are essential to understanding the Company's financial positions, results of operations and cash flows. Certain of these accounting policies require critical accounting estimates that involve complex and subjective judgments and the use of assumptions, some of which may be for matters that are inherently uncertain and susceptible to change. The assumptions and estimates used are based on parameters which are derived from the knowledge at the time of preparing the financial statements and believed to be reasonable under the circumstances. In particular, the circumstances prevailing at this time and assumptions as to the expected future development of the global and industry-specific environment were used to estimate the Company's future business performance. Where these conditions develop differently than assumed and beyond the control of the Company, the actual results may differ from those anticipated (see *Forward-looking information* section above). These estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is changed. Other than the changes made to the underlying assumptions in determining the carrying amount of the goodwill associated with the cash-generating unit related to the Company's Velan ABV S.r.l. ("ABV") subsidiary at February 29, 2016 (as described in note 4 of the Company's audited consolidated financial statements for the year ended February 28, 2017), there were no significant changes made to critical accounting estimates during the past two fiscal years.

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

ACCOUNTING STANDARDS AND AMENDMENTS ISSUED BUT NOT YET ADOPTED

(i) In July 2014, the IASB issued IFRS 9, *Financial Instruments*. The IASB has previously published versions of IFRS 9 that introduced new classification and measurement requirements (in 2009 and 2010) and a new hedge accounting model (in 2013). The July 2014 publication represents the final version of the Standard, replaces earlier versions of IFRS 9 and substantially completes the IASB's project to replace IAS 39, *Financial Instruments: Recognition and Measurement*.

This standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only three classification categories: amortized cost and fair value through other comprehensive income and fair value through profit or loss. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset or liability. The standard introduces a new, expected loss impairment model that will require more timely recognition of expected credit losses. Specifically, the new Standard requires entities to account for expected credit losses from when financial instruments are first recognised and it lowers the threshold for recognition of full lifetime expected losses. The new standard also introduces a substantially-reformed model for hedge accounting with enhanced disclosures about risk management activity and aligns hedge accounting more closely with risk management.

The new standard is effective for annual periods beginning on or after January 1, 2018 with earlier adoption permitted. The Company is currently assessing the impact of this new standard and has not yet determined whether it will early adopt it.

(ii) IFRS 15, *Revenue from Contracts with Customers*, was issued in May 2014 and specifies how and when revenue will be recognized as well as requiring the provision of more informative and relevant disclosures. Its core principle is that an entity will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This core principle is delivered in a five-step model framework: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the entity satisfies a performance obligation. IFRS 15 replaces IAS 11, *Construction contracts*, IAS 18, *Revenue*, IFRIC 13, *Customer Loyalty Programmes*, IFRIC 15, *Agreements for the Construction of Real Estate*, IFRIC 18, *Transfers of Assets from Customers*, and SIC-31, *Revenue - Barter Transactions Involving Advertising Services*.

The new standard is effective for annual periods beginning on or after January 1, 2018 with earlier adoption permitted. For the Company, the standard comes into effect on March 1, 2018. As a result, IFRS 15 will be adopted in the first quarter of the fiscal year ending February 28, 2019. At that time, the Company plans to use the retrospective transition alternative whereby it will restate its comparative results for the current quarter, with an opening adjustment to retained earnings as at March 1, 2017, if applicable.

The Company is continuing to assess the impact of this new standard. The Company has determined that late delivery penalties, which are currently recorded as an expense in cost of sales, will be recorded as a reduction of sales when this standard comes into effect. The preliminary assessment of the effect of this change on the current quarter's results is not significant.

The Company has not yet completed its assessment of the following issues related to this new standard but will provide further updates during the course of the current fiscal year as it advances in its assessment, notably over the following items:

- whether revenue from the sale of goods can continue to be recognized upon their delivery as per the agreed-upon shipping terms or whether some revenue should be recognized at a different time;

- whether the Company needs to further separate elements in a sale of goods contract as separate performance obligations. These could include, but are not limited to the delivery of drawings and documentation, the provision of services (commissioning, inspection, shipping and testing), and warranties.

- the method of allocating revenue to multiple elements in a sale of goods contract where separate performance obligations have been identified.

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

The new standard is effective for annual periods beginning on or after January 1, 2019 with earlier adoption permitted only if IFRS 15 is early adopted. The Company is currently assessing the impact of this new standard and has not yet determined whether it will early adopt it.

(iv) In November 2016, the IFRS Interpretations Committee ("IFRIC") issued IFRIC 22, *Foreign Currency Transactions and Advance Consideration*. This interpretation addresses the exchange rate to use when reporting transactions that are denominated in a foreign currency in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*, in the circumstance in which a customer paid for goods or services in advance.

The interpretation is effective for annual periods beginning on or after January 1, 2018 with earlier adoption permitted. The Company is currently assessing the impact of this new standard and has not yet determined whether it will early adopt it.

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

The interpretation is effective for annual periods beginning on or after January 1, 2019 with earlier adoption permitted. The Company is currently assessing the impact of this new standard and has not yet determined whether it will early adopt it.

CERTAIN RISKS THAT COULD AFFECT OUR BUSINESS

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

Management's Discussion and Analysis

SUMMARY OF RESULTS

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

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

	Fiscal year ended February 28, 2017	Fiscal year ended February 29, 2016	Fiscal year ended February 28, 2015
Operating Data			
Sales	$331,777	$426,895	$455,750
Net Earnings[1]	7,737	3,641	18,580
Earnings per Share			
- Basic	0.36	0.17	0.85
- Diluted	0.36	0.17	0.85
Balance Sheet Data			
Total Assets	519,297	515,627	558,628
Total Long-Term Financial Liabilities	22,532	23,516	12,720
Shareholder Data			
Cash dividends per share			
- Multiple Voting Shares[2]	0.31	0.31	0.36
- Subordinate Voting Shares	0.31	0.31	0.36
Outstanding Shares at report date			
- Multiple Voting Shares[2]	15,566,567		
- Subordinate Voting Shares	6,098,168		

Sales for fiscal year 2017 decreased by 22.3% compared to fiscal year 2016. This decrease was primarily attributable to the lower level of bookings recorded over the course of fiscal year 2016 due in turn to softer demand in our core markets, which negatively impacted the sales volume in fiscal year 2017 . Sales for fiscal year 2016 decreased by 6.3% compared to fiscal year 2015. Sales were negatively impacted by a decrease in bookings, a production slowdown caused by labour unrest and a lockout at the Company's Canadian facilities during the first half of fiscal year 2016, and a stronger U.S. dollar, particularly against the euro.

Gross profit for fiscal year 2017 amounted to $88.5 million, a decrease of $15.8 million from fiscal year 2016. However, gross profit percentage for fiscal year 2017 increased from the 24.4% reported in fiscal year 2016 to 26.7%. While the lower sales volume negatively impacted total gross profit in the year, the increase in the gross profit percentage was mainly attributable to a product mix with a greater proportion of higher margin product sales, material cost savings, as well as labour and overhead savings stemming from the restructuring initiatives implemented in the prior fiscal year. Gross profit for fiscal year 2016 amounted to $104.3 million, a decrease of $14.0 million from fiscal year 2015. Gross profit percentage for fiscal year 2016 also decreased from the 26.0% reported in fiscal year 2015 to 24.4%. The decrease in gross profit percentage reported for fiscal year 2016 is mainly attributable to an increase in material costs as a percentage of sales and unfavourable inventory movements and provisions which were partially offset by decreased labour costs resulting from the restructuring initiatives undertaken in the year.

Administration costs for fiscal year 2017 decreased by $2.1 million when compared to fiscal year 2016. This decrease was achieved despite a $1.2 million increase in costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section). Administration costs for fiscal year 2016 decreased by $10.4 million when compared to fiscal year 2015. This decrease is primarily attributable to a decrease in compensation-related costs, which was mainly due to the restructuring initiatives undertaken in the year, and favourable currency swings resulting from a stronger U.S. dollar, particularly against the euro and Canadian dollar.

The fiscal year 2016 net earnings[1] were also negatively impacted by an $11.5 million non-cash goodwill impairment loss related to the ABV cash-generating unit and restructuring costs of $2.8 million related primarily to the Company's North American and U.K. facilities.

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

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

RECONCILIATIONS OF NON-IFRS MEASURES

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

Net cash

(in millions of dollars)	As at May 31, 2017	As at February 28, 2017	As at May 31, 2016
Cash and cash equivalents	87.4	84.1	101.5
Short-term investments	1.5	1.0	2.1
Bank indebtedness	(22.7)	(7.8)	(6.5)
Short-term bank loans	(1.4)	(1.7)	(1.2)
Current portion of long-term bank borrowings	(3.2)	(3.1)	(2.9)
	61.6	72.5	93.0

Velan Inc.

Unaudited Condensed Interim Consolidated Financial Statements

For the three-month period ended May 31, 2017

Velan Inc.

Condensed Interim Consolidated Statements of Financial Position

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

As At	May 31, 2017 $	February 28, 2017 $
Assets		
Current assets		
Cash and cash equivalents	87,360	84,019
Short-term investments	1,498	974
Accounts receivable	130,812	125,512
Income taxes recoverable	9,787	7,145
Inventories (note 7)	181,761	173,089
Deposits and prepaid expenses	3,766	3,391
Derivative assets	284	1,202
	415,268	395,332
Non-current assets		
Property, plant and equipment	91,815	91,535
Intangible assets and goodwill	19,757	19,023
Deferred income taxes	13,292	12,951
Other assets	403	456
	125,267	123,965
Total assets	540,535	519,297
Liabilities		
Current liabilities		
Bank indebtedness	22,740	7,792
Short-term bank loans	1,395	1,650
Accounts payable and accrued liabilities	58,475	60,641
Income taxes payable	591	946
Dividend payable	1,608	1,631
Customer deposits	49,631	43,953
Provisions	10,860	10,600
Accrual for performance guarantees	28,549	26,943
Derivative liabilities	1,859	799
Current portion of long-term debt	7,410	7,115
	183,118	162,070
Non-current liabilities		
Long-term debt	15,136	15,318
Deferred income taxes	2,863	2,784
Other liabilities	7,453	7,214
	25,452	25,316
Total liabilities	208,570	187,386
Equity		
Equity attributable to the Subordinate and Multiple Voting shareholders		
Share capital (note 8)	73,557	73,584
Contributed surplus	6,026	6,017
Retained earnings	275,424	281,343
Accumulated other comprehensive income (loss)	(29,320)	(35,550)
	325,687	325,394
Non-controlling interest	6,278	6,517
Total equity	331,965	331,911
Total liabilities and equity	540,535	519,297

Commitments and contingencies (note 9)

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

Velan Inc.

Condensed Interim Consolidated Statements of Income (Loss)

(Unaudited)

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

	Three-month periods ended May 31	
	2017 **$**	**2016** **$**
Sales	71,087	77,409
Cost of sales (note 7)	57,596	58,744
Gross profit	13,491	18,665
Administration costs	19,139	18,766
Other expense (income)	296	(107)
Operating profit (loss)	(5,944)	6
Finance income	128	265
Finance costs	152	125
Finance income (costs) – net	(24)	140
Income (Loss) before income taxes	(5,968)	146
Income taxes	(1,382)	(428)
Net income (loss) for the period	(4,586)	574
Net income (loss) attributable to:		
Subordinate Voting Shares and Multiple Voting Shares	**(4,304)**	**528**
Non-controlling interest	(282)	46
	(4,586)	574
Net income (loss) per Subordinate and Multiple Voting Share		
Basic	(0.20)	0.02
Diluted	(0.20)	0.02
Dividends declared per Subordinate and Multiple Voting Share	0.07 (CA$0.10)	0.08 (CA$0.10)
Total weighted average number of Subordinate and Multiple Votng Shares		
Basic	21,665,337	21,737,135
Diluted	21,671,213	21,743,540

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 May 31	
	2017	**2016**
	$	**$**
Comprehensive income (loss)		
Net income (loss) for the period	(4,586)	574
Other comprehensive income (loss)		
Foreign currency translation adjustment on foreign operations whose functional currency is other than the reporting currency (U.S. dollar)	6,273	3,117
Comprehensive income (loss)	1,687	3,691
Comprehensive income (loss) attributable to:		
Subordinate Voting Shares and Multiple Voting Shares	1,926	3,452
Non-controlling interest	(239)	239
	1,687	3,691

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

Velan Inc.

Condensed Interim Consolidated Statements of Changes in Equity

(Unaudited)

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

	Equity attributable to the Subordinate and Multiple Voting shareholders							
	Number of shares	Share capital	Contributed surplus	Accumulated other comprehensive income (loss)	Retained earnings	Total	Non-controlling interest	Total equity
Balance - February 28, 2017	21,667,235	73,584	6,017	(35,550)	281,343	325,394	6,517	331,911
Net income (loss) for the period	-	-	-	-	(4,304)	(4,304)	(282)	(4,586)
Other comprehensive income (loss)	-	-	-	6,230	-	6,230	43	6,273
	21,667,235	73,584	6,017	(29,320)	277,039	327,320	6,278	333,598
Effect of share-based compensation (note 8 (d))	-	-	9	-	-	9	-	9
Share repurchase (note 8 (c))	(2,500)	(27)	-	-	(7)	(34)	-	(34)
Dividends								
Multiple Voting Shares	-	-	-	-	(1,163)	(1,163)	-	(1,163)
Subordinate Voting Shares	-	-	-	-	(445)	(445)	-	(445)
Non-controlling interest	-	-	-	-	-	-	-	-
Balance - May 31, 2017	21,664,735	73,557	6,026	(29,320)	275,424	325,687	6,278	331,965
Balance - February 29, 2016	21,737,135	74,345	5,941	(33,089)	280,380	327,577	5,542	333,119
Net income (loss) for the period	-	-	-	-	528	528	46	574
Other comprehensive income (loss)	-	-	-	2,924	-	2,924	193	3,117
	21,737,135	74,345	5,941	(30,165)	280,908	331,029	5,781	336,810
Effect of share-based compensation (note 8 (d))	-	-	19	-	-	19	-	19
Share repurchase (note 8 (c))	-	-	-	-	-	-	-	-
Dividends								
Multiple Voting Shares	-	-	-	-	(1,174)	(1,174)	-	(1,174)
Subordinate Voting Shares	-	-	-	-	(484)	(484)	-	(484)
Non-controlling interest	-	-	-	-	-	-	-	-
Balance - May 31, 2016	21,737,135	74,345	5,960	(30,165)	279,250	329,390	5,781	335,171

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

Velan Inc.

Condensed Interim Consolidated Statements of Cash Flow

(Unaudited)

(in thousands of U.S. dollars)

	Three-month periods ended May 31	
	2017 **$**	**2016** **$**
Cash flows from		
Operating activities		
Net income for the period	(4,586)	574
Adjustments to reconcile net income to cash provided by operating activities (note 10)	5,345	507
Changes in non-cash working capital items (note 11)	(10,862)	11,805
Cash provided (used) by operating activities	(10,103)	12,886
Investing activities		
Short-term investments	(524)	1,157
Additions to property, plant and equipment	(1,587)	(1,336)
Additions to intangible assets	(147)	(50)
Proceeds on disposal of property, plant and equipment, and intangible assets	59	133
Net change in other assets	55	162
Cash provided (used) by investing activities	(2,144)	66
Financing activities		
Dividends paid to Subordinate and Multiple Voting shareholders	(1,631)	(1,606)
Repurchase of shares (note 8 (c))	(34)	-
Short-term bank loans	(255)	(127)
Repayment of long-term debt	(738)	(1,961)
Cash provided (used) by financing activities	(2,658)	(3,694)
Effect of exchange rate differences on cash	3,298	1,412
Net change in cash during the period	(11,607)	10,670
Net cash – Beginning of the period	76,227	84,340
Net cash – End of the period	64,620	95,010
Net cash is composed of:		
Cash and cash equivalents	87,360	101,556
Bank indebtedness	(22,740)	(6,546)
	64,620	95,010
Supplementary information		
Interest received (paid)	(19)	112
Income taxes reimbursed (paid)	(1,552)	(1,920)

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

For the three-month period ended May 31, 2017

1 General information

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

These unaudited condensed interim consolidated financial statements were approved for issue by the Company's Board of Directors on July 13, 2017. The Company's auditors have not performed a review of these unaudited condensed interim consolidated financial statements.

2 Basis of preparation

These unaudited condensed interim consolidated financial statements for the three-month period ended May 31, 2017 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 28, 2017, which have also been prepared in accordance with IFRS. Accordingly, these unaudited condensed interim consolidated financial statements should be read in conjunction with the Company's annual consolidated financial statements for the year ended February 28, 2017.

3 Future accounting changes

(i) In July 2014, the IASB issued IFRS 9, *Financial Instruments*. The IASB has previously published versions of IFRS 9 that introduced new classification and measurement requirements (in 2009 and 2010) and a new hedge accounting model (in 2013). The July 2014 publication represents the final version of the Standard, replaces earlier versions of IFRS 9 and substantially completes the IASB's project to replace IAS 39, *Financial Instruments: Recognition and Measurement*.

This standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only three classification categories: amortized cost and fair value through other comprehensive income and fair value through profit or loss. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset or liability. The standard introduces a new, expected loss impairment model that will require more timely recognition of expected credit losses. Specifically, the new Standard requires entities to account for expected credit losses from when financial instruments are first recognised and it lowers the threshold for recognition of full lifetime expected losses. The new standard also introduces a substantially-reformed model for hedge accounting with enhanced disclosures about risk management activity and aligns hedge accounting more closely with risk management.

The new standard is effective for annual periods beginning on or after January 1, 2018 with earlier adoption permitted. The Company is currently assessing the impact of this new standard and has not yet determined whether it will early adopt it.

(ii) IFRS 15, *Revenue from Contracts with Customers*, was issued in May 2014 and specifies how and when revenue will be recognized as well as requiring the provision of more informative and relevant disclosures. Its core principle is that an entity will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This core principle is delivered in a five-step model framework: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the entity satisfies a performance obligation. IFRS 15 replaces IAS 11, *Construction contracts*, IAS 18, *Revenue*, IFRIC 13, *Customer Loyalty Programmes*, IFRIC 15, *Agreements for the Construction of Real Estate*, IFRIC 18, *Transfers of Assets from Customers*, and SIC-31, *Revenue - Barter Transactions Involving Advertising Services*.

The new standard is effective for annual periods beginning on or after January 1, 2018 with earlier adoption permitted. For the Company, the standard comes into effect on March 1, 2018. As a result, IFRS 15 will be adopted in the first quarter of the fiscal year ending February 28, 2019. At that time, the Company plans to use the retrospective transition alternative whereby it will restate its comparative results for the current quarter, with an opening adjustment to retained earnings as at March 1, 2017, if applicable.

The Company is continuing to assess the impact of this new standard. The Company has determined that late delivery penalties, which are currently recorded as an expense in cost of sales, will be recorded as a reduction of sales when this standard comes into effect. The preliminary assessment of the effect of this change on the current quarter's results is not significant.

The Company has not yet completed its assessment of the following issues related to this new standard but will provide further updates during the course of the current fiscal year as it advances in its assessment, notably over the following items:

- whether revenue from the sale of goods can continue to be recognized upon their delivery as per the agreed-upon shipping terms or whether some revenue should be recognized at a different time;

- whether the Company needs to further separate elements in a sale of goods contract as separate performance obligations. These could include, but are not limited to the delivery of drawings and documentation, the provision of services (commissioning, inspection, shipping and testing), and warranties.

- the method of allocating revenue to multiple elements in a sale of goods contract where separate performance obligations have been identified.

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

The new standard is effective for annual periods beginning on or after January 1, 2019 with earlier adoption permitted only if IFRS 15 is early adopted. The Company is currently assessing the impact of this new standard and has not yet determined whether it will early adopt it.

(iv) In November 2016, the IFRS Interpretations Committee (“IFRIC”) issued IFRIC 22, *Foreign Currency Transactions and Advance Consideration*. This interpretation addresses the exchange rate to use when reporting transactions that are denominated in a foreign currency in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*, in the circumstance in which a customer paid for goods or services in advance.

The interpretation is effective for annual periods beginning on or after January 1, 2018 with earlier adoption permitted. The Company is currently assessing the impact of this new standard and has not yet determined whether it will early adopt it.

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

The interpretation is effective for annual periods beginning on or after January 1, 2019 with earlier adoption permitted. The Company is currently assessing the impact of this new standard and has not yet determined whether it will early adopt it.

4 Estimates

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

In preparing these unaudited condensed interim consolidated financial statements, the significant judgements made by management in applying the Company’s accounting policies and the key sources of estimation uncertainty were the same as those that applied to the annual consolidated financial statements for the year ended February 28, 2017.

5 Seasonality

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

6 Operating segment information

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

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

7 Inventories

	May 31, 2017 $	February 28, 2017 $
Raw materials	33,547	33,621
Work in process and finished parts	103,265	94,562
Finished goods	44,949	44,906
	181,761	173,089

As a result of variations in the ageing of its inventories, the Company recognized a net inventory provision recovery for the three-month period ended May 31, 2017 of $69, including reversals of $1,829. For the three-month period ended May 31, 2016, the Company recognized a net additional inventory provision of $2,254, including reversals of $2,561.

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

	May 31, 2017 $	February 28, 2017 $
6,098,168 Subordinate Voting Shares (February 28, 2017 – 6,100,668) (notes 8 (c) and 8(d))	66,431	66,458
15,566,567 Multiple Voting Shares	7,126	7,126
	73,557	73,584

c) Pursuant to its Normal Course Issuer Bid, the Company is entitled to repurchase for cancellation a maximum of 153,969 of the issued Subordinate Voting Shares of the Company, representing approximately 2.5% of the issued shares of such class as at October 13, 2016, during the ensuing 12-month period ending October 23, 2017. During the three-month period ended May 31, 2017, 2,500 Subordinate Voting Shares were purchased for a cash consideration of $34 and cancelled. The amount by which the repurchase amount was above the stated capital of the shares had been debited to contributed surplus and retained earnings.

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

During the three-month period ended May 31, 2016, there were no Subordinate Voting Shares repurchased for cancellation.

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

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

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

For the three-month period ended May 31, 2017, a compensation cost of $9 (May 31, 2016 – $19) was recorded in the consolidated statement of income and credited to contributed surplus.

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

	Number of shares	**Weighted average exercise price**	**Weighted average contractual life in months**
Outstanding – February 28, 2017	140,000	$14.50 (CA$19.26)	38.4
Issued	-	-	-
Expired/forfeited	-	-	-
Outstanding – May 31, 2017	140,000	$14.27 (CA$19.26)	35.4
Exercisable – May 31, 2017	60,000	$14.77 (CA$19.94)	

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 three-month period ended May 31, 2017, legal and related costs for these matters amounted to $2,208 (May 31, 2016 – $1,399).

Lawsuits and proceedings or claims arising from the normal course of operations are pending or threatened against the Company. Although at this time it is not possible to determine the outcome, based on the facts currently known, the Company does not believe that the ultimate outcome will have a material adverse effect on its financial position, results of operations or liquidity. No provision has been set up in the accounts.

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

This lawsuit alleges damages to the Facility in excess of $9,000 related to allegedly defective valves supplied by Velan Valve Corp. The claim is for alleged strict product liability and alleged negligence. It is the Company's position that this claim is without merit.

The Company is vigorously defending its position and is undertaking all actions necessary to protect its reputation. While the Company cannot predict the final outcome of this claim, based on information currently available, the Company believes the resolution of this claim will not have a material adverse effect on its financial position, results of operations or liquidity.

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

10 Adjustments to reconcile net income to cash provided from operating activities

	Three-month periods ended May 31,	
	2017 $	2016 $
Depreciation of property, plant and equipment	2,687	2,871
Amortization of intangible assets	435	457
Deferred income taxes	(73)	(703)
Share-based compensation expense (note 8 (d))	9	19
Loss (Gain) on disposal of property, plant and equipment	(21)	45
Net change in derivative assets and liabilities	2,059	(2,674)
Net change in other liabilities	249	492
	5,345	507

11 Changes in non-cash working capital items

	Three-month periods ended May 31,	
	2017 $	2016 $
Accounts receivable	(5,084)	16,145
Inventories	(8,318)	(6,042)
Income taxes recoverable	(2,534)	(1,971)
Deposits and prepaid expenses	(360)	(2,118)
Accounts payable and accrued liabilities	(2,078)	(1,204)
Income taxes payable	(341)	(1,341)
Customer deposits	5,910	8,563
Provisions	271	31
Accrual for performance guarantees	1,672	(258)
	(10,862)	11,805

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

12 Related party transactions and balances

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

	Three-month periods ended May 31,	
	2017 $	2016 $
Affiliated company owned by certain relatives of the controlling shareholder		
Purchases – Material components	131	301
Amount charged by the controlling shareholder to one of the Company's subsidiaries and certain of its executives		
Rent based on weekly usage	12	18
Key management[1] compensation		
Salaries and other short-term benefits	943	973
Share-based compensation	9	19

	May 31, 2017 $	February 28, 2017 $
Accounts payable and accrued liabilities		
Affiliated companies	15	72
Controlling shareholder	12	8

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

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

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