



**KWESST MICRO SYSTEMS INC.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

Three and six months ended March 31, 2021

(Expressed in Canadian Dollars)

**KWESST MICRO SYSTEMS INC.  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
THREE AND SIX MONTHS ENDED MARCH 31, 2021**

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All references in this management's discussion and analysis (the "MD&A") to "KWESST", "we", "us", "our", and the "Company" refer to KWESST Micro Systems Inc. and its subsidiaries as at March 31, 2021.

This MD&A is intended to provide readers with the information that management believes is required to gain an understanding of the current results of KWESST and to assess the Company's future prospects. Accordingly, certain sections of this MD&A contain forward-looking statements that are based on current plans and expectations. These forward-looking statements are affected by risks and uncertainties that are discussed in this MD&A and that could have a material impact on future prospects (see Forward-Looking Statements below). Readers are cautioned that actual events and results will vary.

The MD&A was approved by the Board of Directors on May 27, 2021 and should be read in conjunction with the unaudited consolidated interim financial statements for the three and six months ended March 31, 2021 (herein referred as "2021 Interim FS") and the annual audited consolidated financial statements and related notes for the period ended September 30, 2020 ("Fiscal 2020"). The financial information presented in this MD&A is derived from these 2021 Interim FS prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

All references to \$ or dollar amounts in this MD&A are to Canadian currency unless otherwise indicated.

Additional information, including press releases, relating to KWESST is available for view on SEDAR at [www.sedar.com](http://www.sedar.com).

## **NON-IFRS MEASURES**

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This MD&A makes reference to certain non-IFRS measures such as "EBITDA" and "Adjusted EBITDA". These non-IFRS measures are not recognized, defined or standardized measures under IFRS. Our definitions for these non-IFRS measures will likely differ from that used by other companies and therefore comparability may be limited.

EBITDA and Adjusted EBITDA should not be considered a substitute for or in isolation from measures prepared in accordance with IFRS. These non-IFRS measures should be read in conjunction with the unaudited consolidated interim financial statements and the related notes thereto as at and for the three and six months ended March 31, 2021. Readers should not place undue reliance on non-IFRS measures and should instead view them in conjunction with the most comparable IFRS financial measures. See the reconciliations to these IFRS measures in the "Reconciliation of Non-IFRS Measures" section of this MD&A.

## **GOING CONCERN**

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As an early-stage company, KWESST has incurred significant losses and negative operating cash flows from inception that have primarily been funded from financing activities. KWESST's 2021 Interim FS have been prepared on the "going concern" basis which presumes that KWESST will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future (refer to Note 2(a) of the 2021 Interim FS. While KWESST's remaining working capital at March 31, 2021 was \$0.8 million, on April 29, 2021 KWESST completed a brokered private placement by the issuance of 3,536,057 units of the company at a price of \$1.25 for gross proceeds of over \$4.4 million. Each unit was comprised of one common share of KWESST and one common share purchase warrant. Each warrant is exercisable to acquire one common share at a price of \$1.75 per warrant share for a period of 24 months from the closing of the offering. Refer to the Liquidity and Capital Resources section of this MD&A for further details.

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**FORWARD-LOOKING STATEMENTS**

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Except for statements of historical fact relating to the Company, certain information contained herein constitutes forward-looking information under Canadian securities legislation. Forward-looking statements include, but are not limited to, statements with respect to the Company's proposed acquisitions and strategy, development potential and timetable of the Company's products; the Company's ability to raise required funds; conclusions of economic evaluation; the timing and amount of estimated future products and development; costs of research and development; capital expenditures; success of production activities; currency exchange rates; government regulations; and environmental risks. Generally, forward-looking statements can be identified by the use of forward-looking terminology such as "plans", "expects" or "does not expect", "is expected", "budget", "scheduled", "estimates", "forecasts", "intends", "anticipates" or "does not anticipate", or "believes", or variations of such words and phrases or statements that certain actions, events or results "may", "could", "would", "might" or "will be taken", "occur" or "be achieved".

Forward-looking statements are based on the opinions and estimates of management as of the date such statements are made. Estimates regarding the anticipated timing, amount and cost of production activities are based on previous industry experience and regional political and economic stability. Capital and operating cost estimates are based on significant research of the Company, recent estimates of development costs and other factors that are set out herein. Forward-looking statements are subject to known and unknown risks, uncertainties and other factors that may cause the actual results, level of activity, performance or achievements of the Company to be materially different from those expressed or implied by such forward-looking statements, including but not limited to risks related to:

- our expectations regarding our business, financial condition, and results of operations;
- the impact of the ongoing COVID-19 pandemic, including the duration, severity, scope of the outbreak and measures taken by governments and businesses to contain the pandemic;
- our anticipated cash needs over the next 12 months;
- our ability to protect, maintain, and enforce our intellectual property ("IP") rights;
- our future growth plans, including expansion in international markets;
- the acceptance by our customers and the marketplace of our technologies and system solutions;
- our ability to attract new customers and develop and maintain existing customers;
- our ability to deliver on our marketing and business plans and short-term objectives;
- our ability to attract and retain personnel as well as to obtain required licenses;
- the unexpected events and delays during research and development;
- our ability to generate the anticipated investment returns from acquisitions;
- the future state of the legislative and regulatory regimes, both domestic and foreign, in which we conduct business and may conduct business in the future;
- our ability to raise timely external financing on acceptable terms, when required, to fund our business growth;
- our ability to govern effectively and efficiently as a new public company; and
- anticipated trends and challenges in our business and the markets in which we operate.

These risks are described in further detail in the section entitled "Risks Factors" in our most recently filed Amended Annual Information Form dated April 15, 2021 (herein referred as "AIF"). Although the forward-looking statements contained in this MD&A are based upon assumptions management believes to be reasonable, these risks, uncertainties, assumptions and other factors could cause our actual results, performance, achievements and experience to differ materially from our expectations, future results, performances or achievements expressed or implied by the forward-looking statements. In light of these risks, uncertainties and assumptions, readers should not place undue reliance on forward-looking statements.

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## **OVERVIEW**

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### ***Corporate Information***

KWESST is domiciled in Canada and was incorporated under the Business Corporations Act (British Columbia) on November 28, 2017. Its registered office is located at 550 Burrard St., Suite 2900, Vancouver, British Columbia, V6C 0A3, with its corporate office located at 155 Terence Matthews Crescent, Unit #1, Ottawa, Ontario, Canada, K2M 2A8.

KWESST's common stock is listed on the TSX-Venture Exchange ("TSX-V") under the stock symbol of KWE and on the OTCQB® Venture Market ("OTCQB®"), a US trading platform that is operated by the OTC Markets Group in New York, under the symbol KWEMF.

### ***KWESST's Core Business and Strategy***

KWESST's mission is to be a leader in advancing the modern networked capability of soldiers and responders, including the networked *Soldier Systems* mission of NATO and its allies, with niche applications that make a critical difference to safety and effectiveness.

KWESST develops and markets proprietary technology for applications in the military and homeland security market. KWESST's core technology has multiple applications based on Micro Integrated Systems and Software Technology ("MISST"), a proprietary integration of miniaturized sensors, optics, ballistics and software that provides an advancement in affordable smart systems and mission capability. Current applications and offerings enable: (i) real-time networked situational awareness for soldiers and their weapons systems; (ii) smart management of ordinance systems; (iii) solutions for countering drone attacks and countermeasures against weaponized lasers.

The Company's primary markets are the U.S. and other NATO and NATO partner countries, many of whom have increased their military budgets.

Starting with Q3 Fiscal 2021, KWESST has expanded and diversified its business with the acquisition of the Low Energy Cartridge technology ("LEC Technology") from DEFSEC (see Acquisition section of this MD&A). Based on management's knowledge, the LEC Technology is the world's first cartridge based non-lethal firing system with universal applications across four market segments that currently use a variety of dated "non-lethal" or "less-lethal". These segments are (i) public order (riots and control of dangerous subjects), (ii) military and law enforcement training (realistic force-on-force training), (iii) personal defence (home, car, boat, RV, camping, hiking), and (iv) high-action gaming.

For more details on KWESST products and markets, refer to the AIF. This document and other information about KWESST are available on SEDAR under the Company's profile at [www.sedar.com](http://www.sedar.com).

### ***Business Highlights for the fiscal quarter ended March 31, 2021***

The following is a summary of the key business highlights for KWESST for the fiscal quarter ended March 31, 2021:

- The Board of Directors approved the acquisition of the LEC Technology from DEFSEC, an Ottawa-based private company owned by David Luxton, KWESST's Executive Chairman. The acquisition closed concurrently with the Financing (see below) on April 29, 2021. See Acquisition section of this MD&A for further details on this acquisition.

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- KWESST appointed Canadian Retired General Rick Hillier to chair its International Advisory Council, to provide guidance to the Company on its strategic build-out on a global scale. Due to his prior commitment to chair the Ontario COVID-19 Vaccine Distribution Task Force until end of March 2021, General Hillier will take on this role only during the third quarter ended June 30, 2021. General Hillier served as Canada's Chief of Defence Staff from February 4, 2005, to July 1, 2008.
- KWESST announced that its common shares have been approved for listing on the OTCQB ®, a US trading platform that is operated by the OTC Markets Group in New York. On February 4, 2021, KWESST commenced trading on the OTCQB ® under the symbol KWEMF.
- Elisabeth Preston joined KWESST's Board of Directors and will serve as Corporate Secretary. Elisabeth is currently the Chief Legal Counsel for a top tier international defence company with widespread global operations.
- KWESST entered into a \$0.3 million unsecured loan agreement with a private fund managed by a KWESST shareholder for general corporate purposes. This loan bears interest at 0.5% per month. On May 27, 2021, KWESST repaid the loan, including accrued interest.
- KWESST significantly grew its shareholder base to over 2,000 shareholders as a result of making increased investment in investor relations and digital media promotion.
- We completed the timely integration of TASCs IFM mortar system with ATAK (Android Tactical Assault Kit), a key requirement under the U.S. military contract. ATAK is a pre-eminent battlefield management system used by more than a dozen U.S. government agencies and many NATO allies and partner nations.
- Late in the quarter, KWESST announced the establishment of the ATAK Centre of Excellence based in Ottawa. This centre is expected to facilitate customer requirements for integration into ATAK. It is a natural extension of KWESST's core business around digitizing applications "at the tactical edge" for shared situational awareness and targeting i.e. sharing critical information and high-value applications to the individual soldier on the ground and back up through the chain of command.

Since March 31, 2021:

- KWESST was awarded its first U.S. patent (No. 10,969,467) for its Phantom™ electronic decoy, specifically for the programmable multi-waveform RF generator for use as battlefield decoy. In conjunction with the patent award, KWESST's Phantom™ was selected in defence and innovation programs for evaluation, including a U.S. Special Operations Command program. The first evaluation event will be held in June 2021.
- Under contract to a key U.S. military customer, we have conducted successful U.S. military exercises of TASCs IFM mortar system for 81mm mortar in Hawaii. These exercises provided KWESST with further insight for enhancing the performance of its TASCs IFM mortar system in advance of the second round of U.S. military exercises to be held in North Carolina in July 2021 under the same contract.
- With the significant business expansion (LEC acquisition and creation of the ATAK Centre of Excellence), KWESST augmented its leadership team with the appointment of Rick Bowes as Vice President, Operations for Digitization and Tactical Products. Rick held various senior roles with defence contractors and had a distinguished career as a senior officer in the Canadian Army, retiring in 2003 as a Lieutenant Colonel. Further, KWESST's part-time CFO (Steven Archambault) has agreed to join the Company on a full-time basis effective April 1<sup>st</sup>.

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- KWESST entered into an amended and restated licensing agreement with AerialX to gain exclusive rights to manufacture, operate, and use its drone for the C-UAS (Counter Unmanned Aerial Systems) market, specifically for the United States Department of Defense and Canada's Department of National Defence for a period of two years from the date upon which AerialX will meet certain technical milestones (see 2021 Interim FS – Note 21 (c) for further details on financial terms).
- On April 29, 2021, KWESST closed an over-subscribed brokered private placement for aggregate gross proceeds of more than \$4.4 million (herein referred as "2021 Financing"), providing the Company with significant near-term liquidity and capital to expand and accelerate its business growth strategies. See Liquidity and Capital Resources section of this MD&A for further details on the 2021 Financing.

### ***COVID-19 Impact to Operations***

While the COVID-19 pandemic has caused material changes to the global economic, political, and consumer landscape, there have not been any significant interruptions to our business activities during the latest quarter. We continue to operate at full capacity with no shutdown. Further, the COVID-19 pandemic has not hindered KWESST's ability to meet key performance milestones under its contract with a US military customer for the TASCs IFM, including trials in Hawaii during April 2021. That being said, persistent government-imposed international travel restrictions and lock downs have significantly curtailed our business development activities to promote and conduct sales demonstrations of KWESST's product offerings in overseas markets. While KWESST is encouraged by the global roll-out of government-approved vaccines, a prolonged government-imposed international travel restriction and/or lock down may impede our ability to accelerate our overseas revenue growth plans in the near-term.

To reduce the above risk, KWESST continues to leverage its US-based business development team to pursue U.S. military contract opportunities. Further, the recent launch of the ATAK Centre of Excellence enables us to deliver remotely ATAK integration services anywhere in the world, providing another source of potential revenue in the near term.

### ***Outlook***

With the closing of the LEC Technology acquisition and the 2021 Financing, our near-term priorities are, but not limited to:

- Make further enhancements to the TASCs IFM mortar system in advance of the second U.S. military exercises under the current contract with a key U.S. military customer in July 2021;
- Introduce the TASCs system to the U.S. Army;
- Accelerate the roll-out plan for the LEC product in response to market interest and anticipated high growth across all segments of the non-lethal market where a strong preference is being expressed for a safer, cartridge-based system over traditional systems such as Taser, beanbag shotgun shells, and rubber bullets that can and do result in fatalities;
- Establish KWESST's ATAK Centre of Excellence and pursue business opportunities;
- Accelerate the productization of the Phantom electronic decoy and provide a requested demonstration to the U.S. military in June 2021;
- Accelerate productization of GreyGhost micro-drone missile, to address both the C-UAS and for the emerging counter loitering munitions (C-LM) markets;

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- Implement creative digital solutions to attract customers interests given the lack of tradeshows during this COVID-19 pandemic (e.g. redesign KWESST's website, including adding videos of product offerings); and
- Secure governmental innovation funding for KWESST's innovative products (Phantom, TASCs, and GreyGhost) under the Innovative Solutions Canada Program.

## **ACQUISITIONS**

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To accelerate KWESST's growth plans and respond to market opportunities, we have made the following technology acquisition.

### **LEC Technology**

On April 29, 2021, KWESST completed the acquisition of LEC Technology with DEFSEC, a proprietary non-lethal cartridge-based firing system. This asset acquisition includes all IP rights for the LEC Technology.

The LEC Technology is a proprietary non-lethal cartridge-based ordnance system to address four market segments that currently use a variety of dated "non-lethal" or "less-lethal" products, each having a vast global market. The four market segments as follows are:

- i) Public order (riots and control of dangerous subjects);
- ii) Military and law enforcement training (realistic force-on-force training);
- iii) Personal defence (home, car, boat, RV, camping, hiking); and
- iv) High-action gaming.

With recent events of riots / widespread protests in the U.S. leading to fatalities, management believes the LEC Technology will position KWESST well to address this potentially large market demand for non-lethal weapons.

At closing, KWESST issued 1 million common shares of KWESST (subject to a four-month hold restriction) and 500,000 share purchase warrants of KWESST at \$0.70 each, as previously agreed on June 6, 2020 in a binding letter of agreement. The warrants are subject to vesting with 25% on the first anniversary of the closing of the LEC Technology acquisition and 25% on each of the subsequent three anniversaries.

Additionally, at closing KWESST paid \$150,000 as an advance on future royalties to DEFSEC. Under the technology purchase agreement, KWESST will pay a 7% royalty on annual sales of the LEC Technology, net of taxes, duties, customs brokerage fees, shipping and handling costs, customer credits, discounts and returns, up to a maximum of \$10 million ("Maximum Royalties"). Starting on the second anniversary of the LEC closing date, for each year until the Maximum Royalties have been paid, KWESST agreed to pay the following annual minimum royalty payments:

- a) 2<sup>nd</sup> anniversary: \$150,000;
- b) 3<sup>rd</sup> anniversary: \$150,000;
- c) 4<sup>th</sup> anniversary: \$200,000;
- d) 5<sup>th</sup> anniversary: \$200,000;
- e) 6<sup>th</sup> anniversary: \$250,000;
- f) 7<sup>th</sup> anniversary: \$250,000;
- g) 8<sup>th</sup> anniversary: \$300,000;
- h) 9<sup>th</sup> anniversary: \$300,000;
- i) 10<sup>th</sup> anniversary: \$350,000; and
- j) 11<sup>th</sup> anniversary: \$350,000

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This acquisition constitutes as a related party transaction because DEFSEC is a private company owned by David Luxton, KWESST's Executive Chairman. Mr. Luxton recused himself from the Board deliberations and approval of this acquisition.

**RESULTS OF OPERATIONS**

The following selected financial data has been extracted from 2021 Interim FS.

	Three months ended			Six months ended	
	March 31, 2021	2020	Change %	March 31, 2021	2020
<b>Revenue</b>	\$ 447,684	\$ 48,959	814%	\$ 594,033	\$ 52,700
Cost of sales	331,472	8,104	NM	403,036	15,991
<b>Gross profit</b>	116,212	40,855	184%	190,997	36,709
<i>Gross margin %</i>	26.0%	83.4%		32.2%	69.7%
Operating expenses	2,376,095	577,436	311%	3,955,836	1,376,408
<b>Operating loss</b>	(2,259,883)	(536,581)	321%	(3,764,839)	(1,339,699)
Gain (loss) on derivatives	-	(88,637)	-100%	-	24,541
Gain on government subsidy	3,514	-	NM	3,514	-
Net finance costs	(18,643)	(24,910)	-25%	(36,591)	(77,141)
Foreign exchange income (loss)	(1,776)	5,594	-132%	(5,164)	4,822
<b>Net loss</b>	\$ (2,276,788)	\$ (644,534)	253%	\$ (3,803,080)	\$ (1,387,477)
<b>Adjusted EBITDA <sup>(1)</sup></b>	\$ (1,620,092)	\$ (481,614)	236%	\$ (2,811,336)	\$ (1,260,247)
<b>Earnings (loss) per share - basic and diluted</b>	\$ (0.05)	\$ (0.02)	141%	\$ (0.09)	\$ (0.05)
<b>Weighted average common shares - basic</b>	42,141,523	28,695,065		41,813,109	26,709,694

(1) Adjusted EBITDA is a non-IFRS measure. See "Non-IFRS Measures". See below for "Reconciliation of Non-IFRS Measure".

NM – not meaningful

For the quarter ended March 31, 2021 (herein referred as Q2 Fiscal 2021), KWESST incurred a net loss of \$2.3 million or \$0.05 loss per basic share, compared to net loss of \$0.6 million or \$0.02 loss per basic share for the same period in Fiscal 2020. For the six months ended March 31, 2021 (herein referred as "YTD Fiscal 2021"), KWESST incurred a net loss of \$3.8 million or \$0.09 per share, compared to net loss of \$1.4 million or \$0.05 loss per basic share for the same period in Fiscal 2020.

While KWESST experienced significant revenue growth during Fiscal 2021, it also made significant investments throughout the organization over the last twelve months to position KWESST for success which resulted in incurring operating expenses greater than KWESST's earned gross profit for both periods. See below Operating Expenses ("OPEX") for further details on the increase in OPEX.

**Reconciliation of Non-IFRS Measure**

KWESST has presented EBITDA and Adjusted EBITDA in this MD&A to provide readers with a supplemental measure of our operating performance and thus highlight trends in its core business that may not otherwise be apparent when relying solely on IFRS financial measures. We believe the securities analysts, investors, and other interested parties frequently use non-IFRS measures in evaluating the company's performance. Management also uses non-IFRS measures in order to facilitate operating performance comparisons from period to period, prepare annual operating budgets and assess our ability to meet our capital expenditure and working capital requirements.



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In the following table, EBITDA and Adjusted EBITDA are reconciled to the most comparable IFRS financial measure.

	Three months ended		Six months ended	
	March 31,		March 31,	
	2021	2020	2021	2020
<b>Net loss as reported under IFRS</b>	<b>\$ (2,276,788)</b>	\$ (644,534)	<b>\$ (3,803,080)</b>	\$ (1,387,477)
Net finance costs	18,643	24,910	36,591	77,141
Income tax expense	-	-	-	-
Depreciation	35,018	34,301	75,045	58,786
<b>EBITDA</b>	<b>(2,223,127)</b>	(585,323)	<b>(3,691,444)</b>	(1,251,550)
<i>Other adjustments:</i>				
Share-based compensation	604,773	20,666	878,458	20,666
Loss (gain) on derivatives	-	88,637	-	(24,541)
Gain on government subsidy	(3,514)	-	(3,514)	-
Foreign exchange loss (gain)	1,776	(5,594)	5,164	(4,822)
<b>Adjusted EBITDA loss</b>	<b>\$ (1,620,092)</b>	\$ (481,614)	<b>\$ (2,811,336)</b>	\$ (1,260,247)

For Q2 and YTD Fiscal 2021, KWESST's Adjusted EBITDA loss was \$1.6 million and \$2.8 million, an increase of \$1.1 million and \$1.5 million, respectively, over the comparable periods. Share-based compensation accounted for most of the adjustments to EBITDA. The significant increase in both periods in Fiscal 2021 vs the same periods in Fiscal 2020 is largely due to granting a higher volume of options at a higher fair value per option for recruiting and retaining directors, executives and key business consultants. The total outstanding options was 3.4 million at March 31, 2021, compared to 0.9 million at March 31, 2020. Refer to Note 14 of the 2021 Interim FS for further details on stock option activities. There were no stock options granted prior to Q1 Fiscal 2020.

**Revenue and Gross Profit**

	Quarter ended March 31,			Six months ended March 31,		
	2021	2020	Change	2021	2020	Change
TASCs systems	\$ 444,208	\$ 35,281	\$ 408,927	\$ 583,141	\$ 35,281	\$547,860
Other	3,476	13,678	(10,202)	10,892	17,419	(6,527)
<b>Total revenue</b>	<b>\$ 447,684</b>	\$ 48,959	\$ 398,725	<b>\$ 594,033</b>	\$ 52,700	\$541,333
<b>Gross profit</b>	<b>\$ 116,212</b>	\$ 40,855	\$ 75,357	<b>\$ 190,997</b>	\$ 36,709	\$154,288
<i>Gross margin</i>	<b>26.0%</b>	83.4%		<b>32.2%</b>	69.7%	

For Q2 and YTD Fiscal 2021, total revenue increased by \$0.4 million and \$0.5 million, respectively, over the comparable periods due to growth within the TASCs systems product line. The growth was driven by winning a US\$0.8 million U.S. military contract in late in Q1 Fiscal 2021. Revenue for this contract is being recognized on a percentage of completion based on projected total hours. We expect to fully deliver under this contract by the end of Fiscal 2021. In Q1 Fiscal 2020, KWESST delivered a small contract for another U.S. military customer.

The gross margin was 26.0% and 32.2% for Q2 and YTD Fiscal 2021, respectively, compared to 83.4% and 69.7%, respectively, for the same prior periods. Comparison to prior year gross margins is not meaningful as

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margins will vary based on the size and complexity of the projects, coupled with the varying level of non-recurring engineering involved for each project.

**Operating Expenses (OPEX)**

	Quarter ended March 31,			Six months ended March 31,		
	2021	2020	Change %	2021	2020	Change %
Advertising and promotion	491,437	10,868	4422%	824,327	24,015	3333%
Personnel costs	330,970	183,140	81%	648,473	519,597	25%
Stock-based compensation	604,773	20,666	2826%	878,458	20,666	4151%
Professional fees	279,451	23,653	1081%	395,463	120,293	229%
Consulting fees	147,000	98,213	50%	256,324	229,113	12%
R&D consulting and material costs, net	94,492	37,206	154%	250,785	180,968	39%
Business development	121,887	72,045	69%	224,360	85,545	162%
Travel and conferences	102,396	76,722	33%	124,370	112,744	10%
General and administrative expenses	43,613	12,136	259%	80,520	8,384	860%
Depreciation and amortization	35,018	34,301	2%	75,045	58,786	28%
Insurance	34,946	8,486	312%	59,635	16,297	266%
Impaired intangible assets	55,376	-	NM	55,376	-	NM
Transfer agent & TSX-V fees	24,363	-	NM	61,713	-	NM
Merger and acquisition costs	10,373	-	NM	20,987	-	NM
<b>Total operating expenses</b>	<b>\$ 2,376,095</b>	<b>\$ 577,436</b>	<b>311%</b>	<b>\$ 3,955,836</b>	<b>\$ 1,376,408</b>	<b>187%</b>

NM – not meaningful

Total OPEX increased by 311% or \$1.8 million for the current quarter over the comparable prior period. The increase was driven primarily by:

- \$0.6 million in share-based compensation due to KWESST granting significant stock options since March 31, 2020 to recruit and retain directors, key employees and consultants, compared to a small charge in comparable period because KWESST had only began issuing stock options in February 2020;
- \$0.5 million in advertising and promotion to promote and increase market awareness of KWESST and its new product offerings to position the company for success;
- \$0.3 million in professional fees is mainly due to increase in regulatory compliance costs as a result of going public, coupled with additional legal fees for proposed financing transactions as well as assistance with KWESST's Long-Term Incentive Plan and annual general meeting documents.
- \$0.1 million in personnel costs due to an increase in headcount from six at March 31, 2020 to fourteen at March 31, 2021; and
- \$0.06 million in R&D or \$0.08 million when excluding the investment tax credits mainly due to ramping up product development following the capital raise in Fiscal 2020, with investments allocated to Phantom™, Laser Defense systems, and GreyGhost; project development costs (including building prototypes) for TASCs IFM mortar systems were capitalized as inventories and charged to cost of sales over the sales contract on a percentage of completion to match with the earned revenue; and
- \$0.06 million in impaired intangible assets due to management's assessment on the non-recoverable amount for previously capitalized project development costs.

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Total OPEX increased by 187% or \$2.6 million for YTD Fiscal 2021 over the comparable prior period. The increase was driven by the same reasons as noted above for Q2 Fiscal 2021 in addition to:

- \$0.1 million in business development costs due to entering into a consulting agreement with SageGuild LLC to promote and facilitate the sale of KWESST's product offerings in the United States, coupled with the addition of a sales consultant to focus on the Canadian military market and another U.S. sales consultant under the direction of SageGuild LLC in the latest quarter (effective January 2021 SageGuild LLC is a related party – see Related Party Transactions section of this MD&A);
- \$0.07 million in general and administrative costs mainly due to increase spend for new office location as well as an increase in software licensing fees and telecommunication costs due to an increase in headcount; and
- \$0.06 million in transfer agent and TSX-V fees as a result of being a public company.

***Gain on Derivatives***

In Q1 Fiscal 2019, KWESST issued \$0.6 million of convertible notes and as a result it accounted for the conversion feature as a derivative liability at fair value at closing. This derivative liability is remeasured quarterly with the change in fair value reported in earnings.

Accordingly, KWESST recognized a fair value loss on derivative liability of \$89 thousand for Q2 Fiscal 2020 and a fair value gain of \$25 thousand for YTD Fiscal 2020. The loss incurred in Q2 Fiscal 2020 was due to conversion feature becoming "in-the-money" following a capital raise priced higher than the conversion rate for the convertible notes.

These convertible notes were all converted to KWESST common shares in Q4 of Fiscal 2020 as a result of KWESST going public and accordingly there is no further outstanding derivative liability since September 30, 2020.

***Net Finance Costs***

The following table shows the breakdown of net finance costs:

	Quarter ended March 31,			Six months ended March 31,		
	2021	2020	%	2021	2020	%
Interest expense from:						
Lease obligations	\$ 13,912	\$ 9,571	45%	\$ 28,807	\$ 24,523	17%
Unsecured loan	1,710	-	NM	1,710	-	NM
2019 convertible notes	-	9,683	-100%	-	39,228	-100%
Related party loans	1,883	3,565	-47%	3,953	10,799	-63%
Other	1,138	2,328	-51%	2,121	2,828	-25%
Total interest expense	18,643	25,147	-26%	36,591	77,378	-53%
Interest income	-	(237)	-100%	-	(237)	-100%
Net finance costs	\$ 18,643	\$ 24,910	-25%	\$ 36,591	\$ 77,141	-53%

Total finance costs for Q2 Fiscal 2021 declined by 25% compared to the same quarter in Fiscal 2020. This reduction is primarily due to the conversion of all convertible notes to KWESST common shares as previously

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noted. This was partially offset by an increase in lease obligations due to new office lease starting in Q2 Fiscal 2020.

For YTD Q2 Fiscal 2021, net finance costs declined by 53% compared to the same period in Fiscal 2020 mainly due to the conversion of the 2019 convertible notes to KWESST common shares as noted above, coupled with lower interest costs on related party loans due to partial repayments since March 31, 2020. These cost savings were partially offset by an increase in financing cost for lease obligations for the new office lease.

### **Key Balance Sheet Items**

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The following table summarizes KWESST's financial position:

	<b>March 31, 2021</b>	<b>September 30, 2020</b>
<b>Assets</b>		
Current	<b>\$ 2,553,732</b>	\$ 3,994,888
Non-current	<b>1,306,520</b>	1,512,123
<b>Total assets</b>	<b>\$ 3,860,252</b>	\$ 5,507,011
<b>Liabilities</b>		
Current	<b>\$ 1,784,079</b>	\$ 1,154,234
Non-current	<b>514,027</b>	496,394
<b>Total liabilities</b>	<b>\$ 2,298,106</b>	\$ 1,650,628
<b>Net assets</b>	<b>\$ 1,562,146</b>	\$ 3,856,383

*Changes since September 30, 2020:*

Current assets decreased by \$1.4 million mainly due to working capital used to fund its operations (see Liquidity and Capital Resources section of this MD&A). Trade and other receivables increased to \$0.6 million at March 31, 2021 from \$0.5 million at September 30, 2020, driven mainly by an increase in sales tax recoverable as a result of collection delays caused from Canada Revenue Agency ("CRA") routine audits. CRA completed some of their routine audits in early April 2021 with no change and as a result KWESST has since collected the owed HST input tax credits for those routine audits completed.

Non-current assets decreased by \$0.2 million mainly due to transferring a portion of the intangible assets to inventories as it will be consumed to produce a number of prototypes of the TASCs IFM mortar system for the U.S. military contract (ownership interest to transfer at the end of the contract). The inventories will be fully released to cost of sales as we recognize the related revenue during the remaining Fiscal 2021.

Current liabilities increased by \$0.6 million mainly due to obtaining \$0.3 million of unsecured debt obligation to fund working capital, coupled with \$0.3 million increase in trade payables due to favorable credit terms with certain business partners.

As a result, KWESST's net assets declined by \$2.3 million to \$1.6 million at March 31, 2021 from \$3.9 million at September 30, 2020.

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The following table shows a summary of the rights-of-use assets and related obligations as reported in the 2021 Interim FS:

	March 31, 2021	September 30, 2020
<b>Right-of-use assets</b>	<b>\$ 472,253</b>	\$ 520,440
Lease obligations:		
Current	89,166	78,358
Non-current	463,261	496,394
<b>Lease obligations</b>	<b>\$ 552,427</b>	\$ 574,752

The right-of-use assets excludes the lease deposit to be returned at the end of the lease. The deposit of \$38 thousand was initially recorded at fair value and reported under non-current assets. At March 31, 2021, the carrying value was \$24 thousand.

### SUMMARY OF QUARTERLY RESULTS

The following tables summarize selected results for the eight most recently completed quarters to March 31, 2021.

<i>(\$ in thousands, except per share)</i>	Q2 FY2019	Q3 FY2019	Q4 FY2019	Q1 FY2020	Q2 FY2020	Q3 FY2020	Q4 FY2020	Q1 FY2021	Q2 FY2021
	(restated) <sup>(2)</sup>	(restated) <sup>(1)</sup>	(restated) <sup>(1)</sup>	(restated) <sup>(1),(2)</sup>				(restated) <sup>(3)</sup>	
Revenue	\$ 10	\$ 147	\$ 349	\$ 4	\$ 49	\$ 600	\$ 212	\$ 146	\$ 448
Cost of sales	\$ 10	\$ 5	\$ 62	\$ 8	\$ 8	\$ 144	\$ 95	\$ 72	\$ 332
Gross profit	\$ -	\$ 142	\$ 287	\$ (4)	\$ 41	\$ 456	\$ 117	\$ 74	\$ 116
Gross margin %	0.0%	96.6%	82.2%	-100.0%	83.7%	76.0%	55.2%	50.7%	25.9%
Operating expenses	\$ 187	\$ 235	\$ 217	\$ 799	\$ 577	\$ 1,072	\$ 2,473	\$ 1,580	\$ 2,376
Operating loss	\$ (187)	\$ (93)	\$ 70	\$ (803)	\$ (536)	\$ (616)	\$ (2,356)	\$ (1,506)	\$ (2,260)
Other income (expenses)	\$ (60)	\$ (70)	\$ (64)	\$ 60	\$ (108)	\$ (110)	\$ 160	\$ (21)	\$ (17)
<b>Net income (loss)</b>	<b>\$ (247)</b>	<b>\$ (163)</b>	<b>\$ 6</b>	<b>\$ (743)</b>	<b>\$ (644)</b>	<b>\$ (726)</b>	<b>\$ (2,196)</b>	<b>\$ (1,527)</b>	<b>\$ (2,277)</b>
<b>Adjusted EBITDA (loss)</b>	<b>\$ (246)</b>	<b>\$ (36)</b>	<b>\$ 105</b>	<b>\$ (779)</b>	<b>\$ (482)</b>	<b>\$ (447)</b>	<b>\$ (645)</b>	<b>\$ (1,114)</b>	<b>\$ (1,620)</b>
<b>Earnings (loss) per share - basic and diluted</b>	<b>\$ (0.03)</b>	<b>\$ (0.00)</b>	<b>\$ 0.01</b>	<b>\$ (0.04)</b>	<b>\$ (0.02)</b>	<b>\$ (0.01)</b>	<b>\$ (0.02)</b>	<b>\$ (0.03)</b>	<b>\$ (0.04)</b>
Weighted average common shares - basic	9,751	17,200	18,090	20,768	28,695	30,743	33,025	41,392	42,142

- (1) Other income (expenses) was restated due to cut-off errors in recording the quarterly foreign exchange loss, resulting in reallocating \$32 thousand to Q3 FY2019 and \$9 thousand to Q4 FY2019 with an offset to Q1 FY2020. As a result, the net loss for these periods were also adjusted accordingly. This resulted in no change to the total foreign exchange loss as reported in the audited consolidated financial statements for the year ended December 31, 2019.
- (2) Operating expenses were restated due to cut-off error in recording the reversal of an accrual for consulting fees, resulting in reallocating the reversal of \$85 thousand to Q2 FY2019 from Q1 FY2020. As a result, the net loss for these periods were also adjusted accordingly. This resulted in no change to the total consulting fees as reported in the audited consolidated financial statements for the year ended December 31, 2019.
- (3) Operating expenses were restated to increase it by \$78 thousand for additional share-based compensation expense relating to a partially cancelled option grant.

### Quarterly Results Trend Analysis

KWESST's historical quarterly operating results have been volatile because it is an early-stage company in the pre-commercialization phase. Since KWESST's incorporation in late 2017, we have devoted significant energy to developing our proprietary TASCs system, our signature app and snap-on weapon adaptor that enables real-time streaming of situational awareness data of any kind from any source, including drones, direct to smart devices and operational assets, for a common operating picture and networked engagement. During 2018 and 2019, KWESST also invested significant time in doing demonstrations of our early prototypes to U.S. customers which led to entering into two teaming agreements with AeroVironment Inc. and ManTech International Corporation. These agreements led to more meaningful revenues in Fiscals 2020 and 2021.

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The general trend of increased quarterly operating expenses reflects the investments being made to grow KWESST's business (an increase headcount and facility costs), coupled with significant investments in promoting the Company's profile and its product offerings.

Over the next 12 months, management expects continued volatility in KWESST's quarterly revenue, operating results, and cash flows for the foreseeable future as KWESST continues to invest in promoting KWESST and its product offerings, product development and bringing products to market.

**LIQUIDITY AND CAPITAL RESOURCES**

KWESST has financed its operations to date through the issuance of common shares and to a lesser extent revenue. To fund KWESST's business growth strategies, we may need to raise additional capital from time to time. On April 29, 2021, KWESST raised gross proceeds of \$4.4 million in equity - see 2021 Financing below for further details.

Our approach to managing liquidity is to ensure, to the extent possible, that we always have sufficient liquidity to meet our liabilities as they come due. We do so by continuously monitoring cash flow and actual operating expenses.

KWESST's cash position decreased by \$2.3 million to \$0.7 million at March 31, 2021, from \$3.1 million at September 30, 2020, primarily due to the net operating loss incurred during Q1 Fiscal 2021 offset partially by additional new capital (debt and equity).

Our principal cash requirements are for working capital and product development investments. KWESST's working capital as at March 31, 2021 was approximately \$0.8 million, a reduction of \$2.1 million since September 30, 2020.

The following table provides a summary of cash inflows and outflows by activity:

	Six months ended March 31,		
	2021	2021	%
<b><i>Cash inflows (outflows) by activity:</i></b>			
Operating activities	\$ (3,093,889)	\$ (1,582,161)	96%
Investing activities	(61,250)	(219,815)	-72%
Financing activities	829,147	2,299,138	-64%
<b>Net cash inflows (outflows)</b>	<b>\$ (2,325,992)</b>	<b>\$ 497,162</b>	<b>-568%</b>

*Cash used by operating activities*

As an early-stage company, we continued to invest significantly across the organization. Despite the revenue growth over the prior year, it was not sufficient to cover the increase in overhead costs, professional fees, advertising and promotion costs, and R&D costs. Accordingly, cash flow used in operating activities was \$3.1 million for YTD Fiscal 2021 as compared to \$1.6 million for the comparable prior period, representing an increase of 96%. The increase was driven mainly by an increase in net loss of \$2.4 million for YTD Fiscal 2021, partially offset by higher non-cash items, including \$0.8 million of share-based compensation.

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*Cash used by investing activities*

Cash flow used in investing activities declined by 72% for YTD Fiscal 2021 mainly due to a \$150,000 deposit as an advance for future royalties to AerialX made in the comparable prior period.

*Cash provided by financing activities*

Cash provided by financing activities decreased by 64% for YTD Fiscal 2021 mainly because KWESST raised \$2.5 million of equity in the comparable prior period. In the current fiscal year, KWESST benefitted from its strong stock performance since going public, which led to exercises of options and warrants generating cash flows of \$0.6 million. Further, KWESST received proceeds of \$0.3 million from entering into an unsecured demand loan agreement with a private fund managed by a KWESST's shareholder for general corporate purposes. This unsecured loan agreement is due on the earlier of a change of control (as defined in the agreement) and May 25, 2021 and bears interest at a rate of 0.5% per month. This loan was repaid on May 27, 2021.

**Use of Proceeds from Financing**

The following table provides an approximate breakdown of the funds spent by KWESST from the proceeds raised in September 2020 plus the working capital available at that time as disclosed in KWESST's Filing Statement dated August 28, 2020:

Use of Proceeds	Expected Allocation of Net Proceeds <sup>(2)</sup>	Estimated and Unaudited Actual Use of Funds from September 1, 2020 to March 31 2021	Proceeds unspent as at March 31, 2021
<b>Non-working capital <sup>(1)</sup>:</b>			
Costs related to complete the QT	\$ 150,000	\$ 145,560	\$ 4,440
Broker commissions and fees	189,520	189,520	-
Loan repayment <sup>(3)</sup>	114,049	31,252	82,797
Products development <sup>(4)</sup>	1,395,000	891,667	503,333
	<b>\$ 1,848,569</b>	<b>\$ 1,257,999</b>	<b>\$ 590,570</b>
<b>Working capital:</b>			
Marketing costs	345,000	832,852	(487,852)
Royalties <sup>(5)</sup>	150,000	-	150,000
Unallocated working capital	1,746,237	1,194,701	551,536
<b>Total</b>	<b>\$ 4,089,806</b>	<b>\$ 3,285,552</b>	<b>\$804,254</b>

(1) Excludes non-cash transactions settled in KWESST common shares.

(2) As disclosed in KWESST's Filing Statement dated August 28, 2020.

(3) In May 2021, KWESST has fully repaid the outstanding loans due to KWESST's CEO and another employee.

(4) Includes assembly, testing, tooling and demonstrations - see separate table below.

(5) In connection with the closing of the LEC Technology acquisition, on April 29, 2021, KWESST paid \$150,000 to DEFSEC as an advance for future royalties in accordance with the purchase agreement.

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The following table provides a further breakdown of the investment made in products development noted in the above table:

Products	Expected Allocation of Net Proceeds	Estimated and Unaudited Actual Use of Funds from September 1, 2020 to March 31 2021	Proceeds unspent as at March 31, 2021
TASCS NORs (formerly TASCS Sniper)	\$ 150,000	14,546	\$ 135,454
TASCS IFM <sup>(1)</sup>	150,000	618,890	(468,890)
KWESST LWS	150,000	-	150,000
KWESST LD	425,000	74,875	350,125
Shot Counter	120,000	-	120,000
Phantom	150,000	101,782	48,218
GreyGhost	250,000	81,574	168,426
<b>Total</b>	<b>\$ 1,395,000</b>	<b>\$ 891,667</b>	<b>\$ 503,333</b>

(1) Net of customer funding of \$545 thousand at March 31, 2021. The total spending includes capitalized expenditures as WIP inventory for the U.S. military contract.

As noted in the above table, we allocated more funds to the TASCS IFM product line as a result of winning an additional contract with a U.S. military customer following the trials/testing held in September and November 2020. These trials provided KWESST with constructive feedback for further enhancements to the TASCS IFM mortar system in advance of the extensive U.S. military exercises in April 2021 and July 2021.

### **2021 Financing**

On April 29, 2021, KWESST closed its previously announced over-subscribed brokered private placement, resulting in the issuance of 3,536,057 units ("Units") of KWESST, at a price of \$1.25 per Unit (the "Issue Price"), for aggregate gross proceeds of \$4.4 million (the "Offering"). The estimated net proceeds were as follows:

<b>Gross proceeds</b>	<b>\$ 4,420,071</b>
Less:	
Broker's cash commission	(288,405)
Estimated legal fees and other expenses	(171,666)
<b>Net proceeds</b>	<b>\$ 3,960,000</b>

Under the Offering, KWESST sold a total of 3,536,057 units at a price of \$1.25 per Unit. Each Unit is comprised of one common share of the Company (a "Common Share") and one Common Share purchase warrant ("Warrant"). Each Warrant is exercisable to acquire one Common Share (a "Warrant Share") at a price of \$1.75 per Warrant Share for a period of 24 months from the closing of the Offering. If at any time after four (4) months and one (1) day following the Closing Date, the trading price of the Shares on the TSX Venture Exchange is equal to or exceeds \$3.00 for a period of 10 consecutive trading days, as evidenced by the price at the close of market, KWESST shall be entitled to notify the holders of Warrants of its intention to force the exercise of the Warrants. Upon receipt of such notice, the holders of Warrants shall have 30 days to exercise the Warrants, failing which the Warrants will automatically expire.



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The Offering was completed by PI Financial Corp. and Beacon Securities Limited (the "Agents"). As consideration for the services provided by the Agents in connection with the Offering, the Agents received: (a) a cash commission of \$288,405; and (b) 230,734 compensation options (the "Compensation Options"). Each Compensation Option is exercisable to acquire one unit of the Company (a "Compensation Option Unit") at a price equal to \$1.25 for a period of two years after the closing of the Offering. Each Compensation Option Unit is comprised of one Common Share and one Common Share purchase warrant (a "Compensation Option Warrant"). Each Compensation Option Warrant is exercisable to acquire one Common Share (a "Compensation Option Warrant Share") at a price of \$1.75 per Compensation Option Warrant Share for a period of 24 months from the closing of the Offering.

Directors and officers of KWESST (the "Insiders") purchased 72,000 Units for a total consideration of \$90,000. The issuance of Units to the Insiders constitutes a related party transaction but is exempt from the formal valuation and minority approval requirements of Multilateral Instrument 61-101 - *Protection of Minority Security Holders in Special Transactions* ("MI 61-101") as KWESST's securities are not listed on any stock exchange identified in Section 5.5(b) of MI 61-101 and neither the fair market value of the units issued to the Insiders, nor the fair market value of the entire private placement, exceeds 25% of the Company's market capitalization. KWESST did not file a material change report with respect to the participation of the Insiders at least 21 days prior to the closing of the Offering as the insiders' participations were not determined at that time.

All securities issued in connection with the Offering are subject to a statutory hold period in Canada expiring four (4) months and one (1) day from the closing of the Offering. Additionally, all the directors and officers have agreed to enter into a lock-up agreement for this same period, imposing restriction from selling, disposing, transferring, or pledging their current holdings in KWESST. While conditional approval was granted, the Offering remains subject to final acceptance of the TSX Venture Exchange.

***Revised Allocation of Available Funds***

The following table shows the pro-forma available funds at March 31, 2021, assuming the 2021 Financing closed on this day.

Proforma Available Funds	
Cash at March 31, 2021	\$ 747,768
Net proceeds from 2021 Financing (estimated)	3,960,000
<b>Proforma available funds at March 31, 2021</b>	<b>\$ 4,707,768</b>

With the additional capital, management has allocated KWESST's proforma available funds as follows:

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**Allocation of Proforma Available Funds**

Product development <sup>(1)</sup> :	
TASCS IFM	\$ 400,000
KWESST LWS and LD	200,000
Phantom	500,000
LEC Technology	500,000
ATAK	500,000
GreyGhost	200,000
<b>Total for product development</b>	<b>2,300,000</b>
Repayment of CEO loan <sup>(2)</sup>	191,600
Repayment of unsecured debt <sup>(2)</sup>	310,527
Payment of advance for future royalties to DEFSEC <sup>(3)</sup>	150,000
<b>Total allocated capital</b>	<b>2,952,127</b>
Unallocated - working capital	1,755,641
<b>Total</b>	<b>\$ 4,707,768</b>

(1) Includes concept & design, initial prototype, market testing, and pre-production including a few demo units. Costs includes internal labor costs, outsourced engineering costs, and materials (no overhead allocation).

(2) Repaid in May 2021.

(3) Paid on April 29, 2021.

While management intends to spend the proforma available funds as noted in the above table; there may be circumstances where, for sound business reasons, a reallocation of funds may be necessary.

**Contractual Commitments and Obligations**

The Company's remaining operating lease commitments are for office premises, which will expire in March 2026. Further, KWESST has committed to minimum annual royalty payments to AerialX for its licensed drone (see Note 19 of 2021 Interim FS) as well as to DEFSEC for the LEC Technology acquisition starting from the 2<sup>nd</sup> anniversary from the closing date – April 29, 2021 (see Acquisition section of this MD&A for further details on this acquisition).

At March 31, 2021, KWESST's contractual obligations and commitments were as follows:

<b>Payment due:</b>	<b>Total</b>	<b>Within 1 Year</b>	<b>1 to 3 years</b>	<b>3 to 5 years</b>
Minimum royalty commitments	<b>\$ 1,550,000</b>	\$ 150,000	\$ 500,000	\$ 900,000
Lease obligations	<b>713,328</b>	89,166	305,712	318,450
Accounts payable and accrued liabilities	<b>1,145,929</b>	1,145,929	-	-
Borrowings	<b>367,710</b>	307,710	60,000	-
<b>Total with third parties</b>	<b>3,776,967</b>	1,692,805	865,712	1,218,450
Related party loans	<b>190,977</b>	190,977	-	-
<b>Total contractual obligations</b>	<b>\$ 3,967,944</b>	\$ 1,883,782	\$ 865,712	\$ 1,218,450

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The above table does not include the minimum annual royalty payments that will be due to DEFSEC because the transaction closed subsequent to March 31, 2021. In addition, on April 29, 2021, KWESST paid \$150,000 to DEFSEC as an advance for future royalties in accordance with the purchase agreement – this is also excluded from the above table.

With the additional available capital, management intends to accelerate investments in product and business development in the near term in order to generate revenue sooner. Accordingly, going forward management anticipates the Company's normalized cash burn rate will increase to approximately \$1.25 million per quarter or \$5.0 million per annum, including incremental investments of approximately \$0.4 million per quarter. KWESST's most recent quarterly burn rate has been above this level primarily due to an increased investment in advertising and promotion to raise market awareness on the Company's profile and its product offerings. Management expects a moderate decrease in cash spend for advertising and promotion as well as professional fees going forward.

### **OFF-BALANCE SHEET ARRANGEMENTS**

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We have no off-balance sheet arrangements that have or are reasonably likely to have, a current or future effect on our results of operations, financial condition, revenues or expenses, liquidity, capital expenditures or capital resources.

### **RELATED PARTY TRANSACTIONS**

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Refer to Note 11 of 2021 Interim FS for disclosure about KWESST's related party transactions conducted in the normal course of business. In summary, the related party transactions that occurred during YTD Fiscal 2021 were:

- \$0.01 million repayment of employee loan, including accrued interest;
- \$0.02 million partial repayment of CEO loan, leaving \$0.2 million outstanding March 31, 2021 (this was fully repaid in May 2021);
- \$0.2 million in compensation (cash and share-based) to a consulting firm for providing capital markets advisory services (a significant shareholder of KWESST); and
- \$0.1 million in compensation (cash and share-based) to SageGuild for providing U.S. business development services for Q2 Fiscal 2021 (became a related party only in January 2021 as a result of SageGuild's CEO serving as director for KWESST U.S. subsidiary).

Management believes the above transactions were done at market. At March 31, 2021, there were no outstanding amount in accounts payable and accrued liabilities due to officers and directors of KWESST.

### **FINANCIAL INSTRUMENTS AND OTHER INSTRUMENTS**

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We recognize financial assets and liabilities when we become party to the contractual provisions of the instrument. On initial recognition, financial assets and liabilities are measured at fair value plus transaction costs directly attributable to the financial assets and liabilities, except for financial assets or liabilities at fair value through profit and loss, whereby the transactions costs are expensed as incurred.

Refer to Note 17 of the 2021 Interim FS for disclosure on KWESST's financial instruments.

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**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Refer to Note 2(f) of the Fiscal 2020 audited consolidated financial statements for a discussion of the accounting policies and estimates that are critical to the understanding of our business operations and the results of our operations.

**OUTSTANDING SHARE INFORMATION**

At March 31, 2021, KWESST's authorized capital consists of an unlimited number of common shares with no stated par value.

The following table shows the changes in common shares, options, and warrants since March 31, 2021 to the date of this MD&A, along with total proceeds if all dilutive securities were exercised:

	March 31, 2021	Exercised	Granted	Issued	Converted	May 26, 2021	Proceeds if Exercised	Average price
Common shares	42,507,387	-	-	4,743,557	2,235	47,253,179		
Founders' warrants	8,500,000	-	-	-	-	8,500,000	\$ 1,700,000	\$ 0.20
Broker warrants	161,151	-	-	-	-	161,151	\$ 91,650	\$ 0.57
Warrants	500,000	-	-	4,036,057	-	4,536,057	\$ 7,663,100	\$ 1.69
Stock options	3,397,856	(107,500)	403,125	-	-	3,693,481	\$ 4,508,357	\$ 1.22
Restricted stock units (RSUs)	-	-	-	38,760	(2,235)	36,525	\$ -	
Agents' compensation options:								
Common shares	-	-	-	230,734	-	230,734	\$ 288,418	\$ 1.25
Warrants	-	-	-	230,734	-	230,734	\$ 403,785	\$ 1.75
<b>Total dilutive securities</b>	<b>55,066,394</b>	<b>(107,500)</b>	<b>403,125</b>	<b>9,279,842</b>	<b>-</b>	<b>64,641,861</b>	<b>\$14,655,310</b>	

The common share issuances relate to 2021 Financing, exercised warrants and stock options, and vested RSUs. Further it reflects the issuance of 1 million common shares and 500,000 warrants to DEFSEC in connection with the closing of the LEC Technology.

**DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROLS OVER FINANCIAL REPORTING**

Disclosure controls and procedures ("DC&P") are intended to provide reasonable assurance that material information is gathered and reported to senior management to permit timely decisions regarding public disclosure. Internal controls over financial reporting ("ICFR") are intended to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with IFRS accounting principles.

TSX Venture-listed companies are not required to provide representations in their annual and interim filings relating to the establishment and maintenance of DC&P and ICFR, as defined in Multinational Instrument MI 52-109. In particular, the CEO and CFO certifying officers do not make any representations relating to the establishment and maintenance of (a) controls and other procedures designed to provide reasonable assurance that information required to be disclosed by the issuer in its annual filings, interim filings or other reports filed or submitted under securities legislation is recorded, processed, summarized and reported within the time periods specified in securities legislation, and (b) processes to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with the issuer's GAAP.