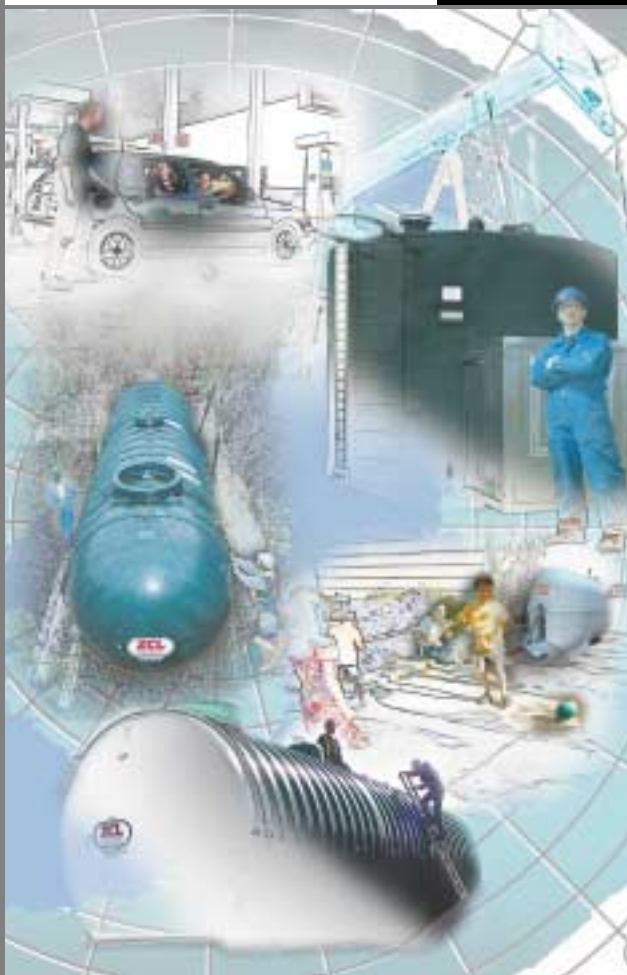


ZCL COMPOSITES INC.
SECOND QUARTER REPORT

2005



Setting a Higher Standard

Message to Shareholders

We are pleased to report record results for the quarter, in terms of both revenue and net income. Revenue for the second quarter increased by 39.6% to \$11.0 million (increased by 13.2% to \$17.3 million for six months) from \$7.9 million (\$15.3 million for six months) last year. Net income for the quarter increased to \$1.2 million (\$1.3 million for six months) from \$97,000 (\$333,000 for six months) in 2003. Basic and diluted earnings per share for the second quarter increased to \$0.07 (\$0.07 for six months) from \$0.01 (\$0.02 for six months) last year.

The outlook for the downstream and upstream sectors of the petroleum industry, as well as other traditional markets, continues to be very positive for this fiscal year. After a slow start, activity and the order backlog picked up during the first quarter and remained strong through the second quarter. The third quarter is also off to a strong start. The steel tank manufacturing business, acquired from Durex Steel & Alloy Industries Ltd. ("Durex") during the first quarter, has been integrated into our overall liquid storage operations and contributed to revenue. Products introduced in recent years – home heating oil tanks, Protector® and Pinnacle™ oilfield tanks, filament wound pressure vessels, as well as custom storage and lining systems – continue to gain market acceptance and add to revenue. In the second quarter last year, the \$880,000 provision for impairment of the agreement receivable from ZCL Enviro Systems, Inc. decreased net income by \$580,000 or \$0.03 per share.

The foundation of our success is meeting and servicing the needs of our customers. During the quarter, we announced another major customer long-term contract. Contracts and recognition such as these are an expression of confidence in ZCL, and our commitment and ability to consistently supply the high quality products and services that our customers value.

It is with this same commitment that we spotlight the development of our tank lining systems. Our lining products adapt proven technology from our double wall tank manufacturing processes and leverage our core competencies and customer relationships. The development program is on schedule and field trials will commence later this fiscal year. Tank lining is a very large and lucrative international market and, at this time, there are no competitive alternative products in the marketplace. We are poised to take advantage of this tremendous opportunity with the anticipated marketing of this product by the end of our fiscal year.

In addition to tank lining, we have targeted the aboveground storage tank (AGST) market for growth. With the acquisition of the business assets of Durex, we now offer a full line of products to our existing alliance customers as well as to new customers. This acquisition allows us to access the retail AGST market which has eluded us until now.

During the quarter, we achieved another significant product milestone. Our home heating oil tank received Underwriters' Laboratories (UL) approval for the USA market – we previously had Underwriters' Laboratories of Canada (ULC) approval and currently sell this product only in Canada. Furnace oil is used for heating in about 8 million households in North America, largely Eastern Canada and North-Eastern USA. A growing concern is leaking tanks and the resulting environmental and liability problems. Our product surpassed industry standards and regulations, and offers a new level of security for home owners, insurance companies and lenders.

I am very pleased to see the improvement in our share price. This increase reflects our performance over the past few quarters. Continued improvement will come from sustained strong financial results, together with an enhanced investor communication program. The first annual dividend of \$0.06 per common share that we announced in the first quarter was paid on August 4, 2004. During the second quarter, the Toronto Stock Exchange accepted our notice to purchase up to five percent of the outstanding common shares under our second normal course issuer bid. We have not made any purchases under this NCIB.

We are solidly on target to realize our annual revenue growth objective of 15% to 20%. Notwithstanding the slow start in the first quarter, we achieved a record second quarter and I am confident that we can reach this target again this year. With the support of our dedicated customers, employees, and shareholders, we will continue to deliver quality products to our customers and create value for our shareholders.



Venence G. Côté
President and Chief Executive Officer

November 5, 2004

Management's Discussion and Analysis

November 5, 2004

The following discussion and analysis of the results of operations and cash flows for the period ended September 30, 2004, and the financial position as at September 30, 2004, should be read in conjunction with the Company's unaudited consolidated financial statements and related notes for the period ended September 30, 2004, the Management's Discussion and Analysis and audited consolidated financial statements and related notes for the year ended March 31, 2004, as well as the Message to Shareholders included in this Second Quarter Report.

This discussion includes forward-looking statements that are based on current expectations and are subject to risks and uncertainties. Many internal and external factors may cause actual results to differ materially, including, but not limited to, those outlined in Risks and Uncertainties in the Management's Discussion and Analysis for the year ended March 31, 2004. The Company disclaims any intention or obligation to update or revise any such forward-looking statements, whether as a result of new information, future events, or otherwise.

OVERALL PERFORMANCE

The Company used the same accounting policies and methods for the period ended September 30, 2004 as used in the audited annual consolidated financial statements for the year ended March 31, 2004. The consolidated statements of income and retained earnings (deficit) and cash flows for interim periods are not necessarily indicative of results on an annual basis due to seasonal and short-term variations. The Company operates in one reportable segment, which is the manufacture and distribution of liquid storage systems including fiberglass underground and aboveground storage tanks and related products and accessories. Historically, the second and third quarters have the highest levels of activity, corresponding to the seasonality of the installation of underground liquid storage systems in Canada.

Revenue in the second quarter increased by 39.6% to \$11.0 million (increased by 13.2% to \$17.3 million for six months) from \$7.9 million (\$15.3 million for six months) last year. Net income for the quarter increased to \$1.2 million (\$1.3 million for six months) from \$97,000 (\$333,000 for six months) in 2003. Basic and diluted earnings per share for the second quarter increased to \$0.07 (\$0.07 for six months) from \$0.01 (\$0.02 for six months) last year.

The outlook for the downstream and upstream sectors of the petroleum industry, as well as other traditional markets, continues to be very positive for this fiscal year. After a slow

start, activity and the order backlog picked up during the first quarter and remained strong through the second quarter. The third quarter is also off to a strong start. The steel tank manufacturing business, acquired from Durex Steel & Alloy Industries Ltd. ("Durex") during the first quarter, has been integrated into the overall liquid storage operations and contributed to revenue. Inventories have been maintained at higher levels to meet orders and deliveries during the second and third quarters.

The increase in net income and earnings per share in the second quarter and six-month period as compared to last year was due to the higher revenue. In the second quarter last year, the \$880,000 provision for impairment of the agreement receivable from ZCL Enviro Systems, Inc. ("Enviro") decreased net income by \$580,000 or \$0.03 per share.

Cash used in operating activities during the second quarter this year was \$202,000 (\$730,000 for six months), compared to cash flows from operating activities of \$1.0 million (\$1.6 million for six months) last year. This decrease was largely due to the timing of sales (high sales later in the period with the resulting higher level of accounts receivable at September 30, 2004) and the build-up of inventories this year. The first annual dividend of \$0.06 per common share was declared in the first quarter this year and dividends of \$1.1 million were paid in the second quarter. The business assets of Durex were purchased for cash of \$1.2 million in the first quarter this year.

The effect of dilutive share options and warrants was 1,145,718 shares (2003 – nil) for the second quarter and 1,037,155 shares for the six-month period (2003 – nil). During the first quarter this year, the first performance threshold with respect to the warrants, of \$1.90 per common share, was reached and one-third of the warrants vested. In 2003, share options were not included in the calculation of diluted shares as their exercise prices exceeded the average market share price for the period, and the warrants were not included as the market share price was below the performance vesting thresholds.

The Company continues to focus on the development and marketing of its tank lining technologies, as well as other new products. In conjunction with customers and suppliers, the Company is working to develop new lining materials and processes in order to deliver a product with superior quality and performance, along with inherently safe installation techniques.

Field testing is scheduled to commence later this fiscal year. Product development costs of \$97,000 (2003 – nil) in the second quarter and \$232,000 (2003 – nil) for the six-month period were deferred.

RESULTS OF OPERATIONS

Period Ended September 30, 2004 Compared to the Period Ended September 30, 2003

Revenue

Revenue in the second quarter increased by 39.6% to \$11.0 million (increased by 13.2% to \$17.3 million for six months) from \$7.9 million (\$15.3 million for six months) last year. The majority of the increase was due to the strong level of activity in the downstream and upstream sectors of the petroleum industry in the second quarter. Activity picked up in the latter part of the first quarter, and continued through the second quarter. In addition, the steel tank manufacturing business, acquired from Durex during the first quarter, has been integrated into the overall liquid storage operations and contributed to revenue. Products introduced in recent years – home heating oil tanks, Protaktor® and Pinnacle™ oilfield tanks, filament wound pressure vessels, as well as custom storage and lining systems – continue to gain market acceptance and add to revenue.

Revenue less manufacturing and selling costs

Revenue less manufacturing and selling costs increased to \$2.9 million (25.9% of revenue) from \$2.0 million (25.9% of revenue) in the second quarter last year, and to \$3.9 million (22.5% of revenue) from \$3.5 million (22.8% of revenue) for the six-month period. This increase is the result of the higher revenue.

Manufacturing and selling costs include direct materials and labour, variable and fixed manufacturing overhead, and marketing and selling expenses, and exclude amortization, general and administration, and financing charges. Overall manufacturing margins continue to be maintained at similar levels as last year, with production improvements and higher selling prices offsetting the impact of increased raw material input costs. Manufacturing overhead and marketing and selling expenses have generally been maintained at similar levels as last year, but certain higher expenses were incurred to support the increased operations and sales activity.

Amortization

Amortization decreased to \$477,000 (2003 – \$495,000) for the second quarter and to \$945,000 (2003 – \$999,000)

for the six-month period. The overall level of amortization has decreased, and will further diminish by the end of fiscal 2005, as certain deferred costs related to past start-up operations and acquisitions are fully amortized.

Additional lining development costs were deferred during the second quarter, and will continue in fiscal 2005. These additional costs are not anticipated to exceed \$500,000 and will be amortized upon the commercial production of the lining products.

General and administration

General and administration expenses were \$494,000 or 4.5% of revenue (2003 – \$409,000 or 5.2% of revenue) for the second quarter and \$923,000 or 5.3% of revenue (2003 – \$844,000 or 5.5% of revenue) for six months. These costs have generally been maintained at the same level as last year, but will increase as the Company grows and processes are put in place relating to the requirements of current corporate governance developments. General and administration expenses include the accrual of management incentives of \$55,000 (2003 – \$20,000) for the second quarter and \$55,000 (2003 – \$40,000) for the six-month period.

Provision for impairment of agreement receivable

As described in note 6 to the unaudited consolidated financial statements for the period ended September 30, 2004, during the second quarter of last year a provision for impairment of the full amount of the agreement receivable from Enviro of \$880,000 was recorded. Since that time, actions continue to be pursued to collect the amount receivable, but no additional recoveries have been received.

Financing charges

Financing charges for the second quarter were \$40,000 (\$43,000 for six months), down from \$81,000 (\$195,000 for six months) last year. The decrease is the result of the repayment of long-term bank debt and write-off of related deferred finance costs in the third quarter last year. Short-term interest increased from last year with the utilization of the bank operating lines of credit (bank indebtedness) this year. Foreign exchange gains or losses, included in financing charges, were not significant.

Income taxes

The Company's effective tax rate was 33.4% in the second quarter (34.4% for six months), as compared to 45.5% (41.0% for six months) last year. The Company's statutory

income tax rate is approximately the same as last year; the decrease in the effective rate was due to non-deductible expenses that are not significant but had a relatively large effect last year because of the low level of pre-tax income.

The Company was in a taxable position in the second quarter this year. The majority of tax losses of prior years have been utilized, and current future tax assets largely represent the remaining tax losses that are available and anticipated to be utilized over the next year.

LIQUIDITY AND CAPITAL RESOURCES

Working capital (current assets less current liabilities) at September 30, 2004 was \$10.0 million, as compared to \$10.1 million at March 31, 2004. Current assets increased by \$2.0 million and current liabilities increased by \$2.1 million. At September 30, 2004, accounts receivable increased by \$2.3 million from March 31, 2004 to \$8.7 million, inventories increased by \$1.5 million to \$7.1 million, accounts payable and accrued liabilities increased by \$449,000 to \$5.0 million, and income taxes payable increased by \$339,000 to \$374,000. These increases reflect the elevated level of operations during the period. Inventories have been increased to meet the higher level of activity in the third quarter. Income taxes payable increased as a result of the current tax provision for the period.

No one customer generally makes up more than 10% of revenue, but at a particular point in time, depending on the timing of sales, there may be higher proportionate exposure in accounts receivable. At September 30, 2004, the two largest customers accounted for approximately 20% (March 31, 2004 – two customers, 26%) of accounts receivable.

As a result of the use of cash during the period, net advances on the revolving operating lines of credit (bank indebtedness) were \$1.2 million (2003 – nil) during the second quarter and \$1.3 million (2003 – nil) for the six-month period. The Company has operating lines of credit of \$10.3 million provided by a chartered bank.

Cash used in operating activities during the second quarter this year was \$202,000 (\$730,000 for six months), compared to cash flows from operating activities of \$1.0 million (\$1.6 million for six months) last year. This decrease was largely due to the timing of sales (high sales later in the period with the resulting higher level of accounts receivable at September 30, 2004) and the build-up of inventories this year.

During the second quarter this year, dividends of \$1.1 million (2003 – nil) were paid and share options and

warrants were exercised for cash of \$226,000 (2003 – nil). Last year, long-term debt of \$179,000 was repaid in the second quarter (\$358,000 for six months last year). The business assets of Durex were purchased for cash of \$1.2 million in the first quarter this year. Product development costs, related to lining materials and processes, of \$97,000 (2003 – nil) in the second quarter and \$232,000 (2003 – nil) for the six-month period were deferred.

During the second quarter this year, the Toronto Stock Exchange ("TSX") accepted notice of a normal course issuer bid ("2004 NCIB") filed by the Company. For the twelve-month period commencing August 19, 2004 and ending August 18, 2005, the Company may purchase on the TSX up to a maximum of 875,566 common shares, being approximately 5% of the issued and outstanding common shares. The actual number and timing of any purchases will be determined by the Company, and the price for any such shares will be the market price at the time. The Company believes that, from time to time, its common shares have been trading at a price range which does not adequately reflect their value in relation to the assets, business and future prospects. No shares have been purchased pursuant to the 2004 NCIB. The normal course issuer bid filed by the Company last year ("2003 NCIB") expired on July 9, 2004. During the second quarter last year, 1,000 common shares were repurchased for cancellation under the 2003 NCIB (during fiscal 2004, a total of 222,000 shares were purchased under the 2003 NCIB).

TRANSACTIONS WITH RELATED PARTIES

The related party transactions are described in note 9 to the unaudited consolidated financial statements for the period ended September 30, 2004. There are no ongoing contractual or other commitments resulting from these transactions.

OUTLOOK

The Company's outlook remains as described in the Management's Discussion and Analysis included in the March 31, 2004 Annual Report.

OTHER

Outstanding Share Data

As at November 5, 2004, there were 17,810,586 common shares, 1,250,734 share options and 3,539,211 warrants outstanding.

Consolidated Balance Sheets

(Unaudited)

(in thousands of dollars)	September 30 2004 \$	March 31 2004 \$
Assets		
Current		
Cash	—	1,880
Accounts receivable	8,682	6,363
Inventories	7,103	5,556
Prepaid expenses	588	188
Future tax assets	324	699
	16,697	14,686
Property, plant and equipment	8,454	7,814
Deferred costs (note 3)	606	717
Intangible assets	1,306	1,324
Goodwill	1,991	1,926
	29,054	26,467
Liabilities and Shareholders' Equity		
Current		
Bank indebtedness (note 4)	1,328	—
Accounts payable and accrued liabilities	4,974	4,525
Income taxes payable	374	35
Future tax liabilities	27	27
	6,703	4,587
Government grants	156	160
Future tax liabilities	793	838
	7,652	5,585
Shareholders' equity		
Share capital (note 5a)	19,079	18,853
Contributed surplus (note 5a and 5b)	121	77
Retained earnings	2,202	1,952
	21,402	20,882
	29,054	26,467

See accompanying notes

Consolidated Statements of Income and Retained Earnings (Deficit)

(Unaudited)

Periods ended September 30

	Three months		Six months	
	2004	2003	2004	2003
(in thousands of dollars, except per share amounts)	\$	\$	\$	\$
Revenue	11,020	7,896	17,328	15,305
Manufacturing and selling costs	8,164	5,853	13,435	11,823
	2,856	2,043	3,893	3,482
Amortization (note 3)	477	495	945	999
General and administration	494	409	923	844
Provision for impairment of agreement receivable (note 6)	—	880	—	880
Financing charges	40	81	43	195
Income before income taxes	1,845	178	1,982	564
Income taxes				
Current	346	6	351	11
Future	270	75	330	220
	616	81	681	231
Net income for the period	1,229	97	1,301	333
Retained earnings (deficit), beginning of the period	973	(8,807)	1,952	(9,043)
Deficit elimination (note 5a)	—	9,043	—	9,043
Dividends (note 7)	—	—	(1,051)	—
Retained earnings, end of the period	2,202	333	2,202	333
Basic and diluted earnings per share (note 8)	\$0.07	\$0.01	\$0.07	\$0.02

See accompanying notes

Consolidated Statements of Cash Flows

(Unaudited)

Periods ended September 30

	Three months		Six months	
	2004	2003	2004	2003
(in thousands of dollars)	\$	\$	\$	\$
Cash Flows from Operating Activities				
Cash receipts from customers	7,924	7,585	14,917	15,359
Cash paid to suppliers and employees	(8,088)	(6,421)	(15,599)	(13,616)
Interest paid	(33)	(122)	(36)	(149)
Income taxes paid	(5)	(14)	(12)	(21)
	(202)	1,028	(730)	1,573
Cash Flows from Financing Activities				
Net advances on bank indebtedness (note 4)	1,213	—	1,328	—
Issue of common shares (note 5a)	226	—	226	—
Dividends (note 7)	(1,051)	—	(1,051)	—
Repayment of long-term debt	—	(179)	—	(358)
Repurchase of common shares for cancellation (note 5a)	—	(1)	—	(1)
	388	(180)	503	(359)
Cash Flows from Investing Activities				
Business acquisition (note 2)	—	—	(1,193)	—
Purchase of property, plant and equipment	(89)	(129)	(228)	(271)
Deferred development costs (note 3)	(97)	—	(232)	—
	(186)	(129)	(1,653)	(271)
Increase (decrease) in cash	—	719	(1,880)	943
Cash, beginning of the period	—	1,557	1,880	1,333
Cash, end of the period	—	2,276	—	2,276

See accompanying notes

Notes to Consolidated Financial Statements

September 30, 2004 and 2003 (Unaudited)

1. Financial Statement Presentation and Significant Accounting Policies

These unaudited interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles on a basis consistent with those used in the preparation of the most recent annual consolidated financial statements. These unaudited interim consolidated financial statements do not include all the information and disclosures required for annual financial statements and should be read in conjunction with the Company's consolidated financial statements for the year ended March 31, 2004. In management's opinion, the interim consolidated financial statements include all adjustments necessary to present fairly such interim financial information.

The consolidated statements of income and retained earnings (deficit) and cash flows for interim periods are not necessarily indicative of results on an annual basis due to seasonal and short-term variations. Historically, the second and third quarters of the Company's fiscal year have the highest levels of activity, corresponding to the seasonality of the installation of underground liquid storage systems in Canada.

2. Business Acquisition

In May 2004, the Company acquired the business assets of Durex Steel & Alloy Industries Ltd. ("Durex") located in Edmonton, Alberta. Durex manufactures steel aboveground storage tanks.

The acquisition was accounted for using the purchase method and the consolidated financial statements include the results of operations from May 7, 2004. Cash consideration for the purchase was \$1,193,000, including acquisition costs. The fair value of assets acquired was as follows:

(in thousands of dollars)	\$
Inventories	128
Property, plant and equipment	800
Non-contractual customer relationships	50
Product certification and safety marks	150
Goodwill	65
Total assets acquired	1,193

Amortization of non-contractual customer relationships is computed using the straight-line method over three years. Product certification and safety marks are indefinite life assets and are not subject to amortization. Of the amount of goodwill, 75% is deductible for income tax purposes.

3. Deferred Costs and Amortization

The unamortized balance of deferred costs at September 30, 2004 was comprised of deferred development costs of \$606,000 (March 31, 2004 - \$717,000). Product development costs of \$97,000 for the second quarter (2003 - nil) and \$232,000 for the six-month period (2003 - nil) were incurred. These costs incurred related to development projects in process at September 30, 2004 and were not amortized during the period. The total amount of research and development charged to expense for the period is not separately identifiable, as such costs are only tracked for development projects that are deferred.

Amortization expense consists of amortization of the following:

Periods ended September 30 (in thousands of dollars)	Three months		Six months	
	2004	2003	2004	2003
	\$	\$	\$	\$
Property, plant and equipment	198	178	388	366
Deferred development costs	171	178	343	355
Deferred startup costs	—	35	—	70
Intangible assets	110	106	218	212
Government grants	(2)	(2)	(4)	(4)
	477	495	945	999

4. Bank Indebtedness

The Company has operating lines of credit of \$10,250,000 provided by a chartered bank. These lines of credit are payable on demand and bear interest at prime rate plus 0.25% (4.25%; March 31, 2004 - 4.25%). The operating lines of credit contain certain restrictive covenants including the maintenance of certain financial ratios and limitations on capital expenditures and additional debt. The Company has pledged as collateral a general security agreement, guarantees of subsidiaries, and a pledge of inventory under section 427 of the Bank Act.

5. Share Capital, Contributed Surplus and Stock-Based Compensation

a) Share capital

Issued and outstanding:

(in thousands of dollars, except shares)	2004		2003	
	# Shares	\$	# Shares	\$
Balance, as at March 31 and June 30	17,511,320	18,853	17,716,920	27,378
Reduction of stated capital	—	—	—	(8,298)
Share options exercised for cash	102,600	98	—	—
Warrants exercised for cash	135,000	128	—	—
Repurchased under normal course issuer bid	—	—	(1,000)	(2)
Balance, as at September 30	17,748,920	19,079	17,715,920	19,078

At the Annual General and Special Meeting of Shareholders on August 18, 2003, the shareholders approved the reduction of the stated capital of the Company. Accordingly, in 2003, contributed surplus was reduced by \$745,000, share capital by \$8,298,000, and accumulated deficit by \$9,043,000.

During 2003, 1,000 common shares were repurchased for cancellation pursuant to a normal course issuer bid at a cost of \$1,000. As a result, share capital was reduced by \$2,000 and contributed surplus was increased by \$1,000.

b) Stock-based compensation

The Black-Scholes model, used by the Company to calculate the values of options and warrants, as well as other currently accepted option valuation models, were developed to estimate the fair value of freely-tradeable, fully-transferable options and warrants without vesting restrictions. Such options and warrants differ significantly from the share options granted and warrants transferred by the Company. These models require subjective assumptions, including future share price volatility and expected time until exercise, which affect the calculated values. Accordingly, management believes that these models do not necessarily provide a reliable single measure of the fair values of the share options granted and warrants transferred by the Company.

Share options granted and warrants transferred on or after April 1, 2003

The Company uses the fair value method of accounting for all share options granted and warrants transferred to employees on or after April 1, 2003. During the first quarter,

the Company granted 260,000 share options (2003 – nil), all of which were granted with exercise prices at the market share price on the grant date, and transferred to employees 230,000 warrants (2003 – nil), all of which were transferred with exercise prices below the market share price on the transfer date. \$25,000 (2003 – \$3,000) in the second quarter and \$36,000 (2003 – \$4,000) in the six-month period were recorded as contributed surplus and an expense in manufacturing and selling costs in the statements of income.

The following estimated fair values of these share options and warrants were determined, at the date of the grants or transfers, using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Share Options		Warrants	
	Granted at Market	Granted in Excess of Market	Transferred in Excess of Market	Transferred Below Market
Weighted-average fair value	\$0.65	\$0.29	\$0.18	\$0.74
Risk-free interest rate (%)	3.77	3.89	4.37	3.77
Expected hold period to exercise (years)	4.0	4.0	4.5	3.3
Volatility in the price of the Company's shares (%)	55.5	60.8	60.5	51.4
Dividend yield (%)	0.00	0.00	0.00	0.00

In addition, in accordance with the fair value method of accounting for stock-based compensation for non-employees, \$4,000 (2003 – nil) in the second quarter and \$8,000 (2003 – nil) in the six-month period were recorded as contributed surplus and a general and administration expense in the statements of income.

Share options granted and warrants transferred in fiscal 2003

The fair value of share options granted and warrants transferred in fiscal 2003, all of which were granted or transferred with exercise prices in excess of the market share price on the grant or transfer date, were determined, at the date of grants or transfers, using the Black-Scholes option pricing model. The following table provides the required pro-forma measures of net income and earnings per share had compensation expense been recognized based on the fair value, as at the date of the grant or transfer, of the options granted and warrants transferred to employees in fiscal 2003, in accordance with the fair value method of accounting for stock-based compensation:

5. Share Capital, Contributed Surplus and Stock-Based Compensation – continued

Periods ended September 30 (in thousands of dollars)	Three months		Six months	
	2004	2003	2004	2003
	\$	\$	\$	\$
Net income for the period	1,229	97	1,301	333
Compensation expense	49	53	103	109
Pro-forma net income for the period	1,180	44	1,198	224
Earnings per share:				
Reported basic and diluted earnings per share	0.07	0.01	0.07	0.02
Compensation expense per share	0.00	0.01	0.01	0.01
Pro-forma basic and diluted earnings per share	0.07	0.00	0.06	0.01

The following estimated fair values of these options and warrants were determined using the following weighted-average assumptions:

	Share Options	Warrants
Weighted-average fair value	\$0.37	\$0.38
Risk-free interest rate (%)	4.0	4.0
Expected hold period to exercise (years)	4.0	5.0
Volatility in the price of the Company's shares (%)	61.6	56.2
Dividend yield (%)	0.00	0.00

6. Agreement Receivable

ZCL Enviro Systems, Inc. had not made any payments under an agreement receivable since the fourth quarter of fiscal 2003, and due to current business conditions in the Philippines, has been unable to commit to a revised repayment schedule. The amounts and timing of future repayment, and the fair value of underlying security, net of expected costs of recovery, could not be estimated with reasonable reliability. Accordingly, during the second quarter of fiscal 2004, a provision for the full amount of the agreement receivable of \$880,000 was recorded.

7. Dividends

On June 17, 2004, an annual dividend of \$0.06 per common share was declared for all shareholders of record on July 14, 2004. The dividends of \$1,051,000 were paid on August 4, 2004.

8. Earnings Per Share

The following table sets forth the weighted-average number of common shares outstanding for the computation of basic and diluted earnings per share:

Periods ended September 30	Three months		Six months	
	2004	2003	2004	2003
Weighted-average shares for basic earnings per share	17,568,137	17,716,083	17,539,884	17,716,499
Weighted-average shares for diluted earnings per share	18,713,855	17,716,083	18,577,039	17,716,499

Share options and warrants were not included in the calculation of diluted shares in 2003 as their exercise prices exceeded the average market share price or the market price was below the performance vesting thresholds.

9. Related Party Transactions

Trucking services of \$94,000 (2003 – \$160,000) for the second quarter, and \$175,000 (2003 – \$232,000) for the six-month period, were provided by a corporation controlled by a director of the Company. Accounts payable and accrued liabilities at September 30, 2004 included \$14,000 (March 31, 2004 – \$6,000) owing to the corporation. Normal commercial rates were paid for these services.

10. Derivative Financial Instruments

At September 30, 2004, the Company had entered into foreign currency collar arrangements not accounted for as hedges. These arrangements provided for the purchase of euros, up to a total Canadian dollar equivalent of \$265,000 (March 31, 2004 – \$1.5 million), at a rate of \$1.566 per euro. The fair value of these arrangements, estimated using market rates at September 30, 2004, was nil (March 31, 2004 – nil). During the three-month and six-month periods, net realized and unrealized losses of less than \$1,000 (2003 – nil) relating to derivative financial instruments were recorded in financing charges.

Corporate Information

Board of Directors

James S. Edwards, Chairman of the Board

Venence G. Côté, Director, President and CEO

Fred J. Dymont, Director

Simon Sochatsky, Director

Transfer Agent & Registrar

Olympia Trust Company

Calgary, Alberta

Auditors

Ernst & Young LLP

Edmonton, Alberta

General Counsel

Parlee McLaws LLP

Edmonton, Alberta

Stock Listing and Share Symbol

Toronto Stock Exchange: **ZCL**



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