

Second Quarter Report 2004

ZCL
COMPOSITES INC.



Message to Shareholders

After achieving a 45% increase in revenue for a record first fiscal quarter, revenue for the second quarter ended September 30, 2003 was \$7.9 million, down 1.6% from last year. Accordingly, for the six-month period, revenue was \$15.3 million, up 16.5% from last year. The third quarter has started off well and we are on target to meet our growth objectives on an annual basis.

Net income for the second quarter was \$97,000, or \$0.01 per share (\$333,000 or \$0.02 per share for six months), as compared to income of \$737,000, or \$0.05 per share (\$644,000 or \$0.02 per share for six months), last year. The provision for impairment of the agreement receivable from ZCL Enviro Systems, Inc. ("Enviro") decreased net income by \$580,000 or \$0.03 per share. Last year, convertible subordinated debenture costs of \$245,000 were deducted in the calculation of earnings per share in the second quarter (\$461,000 for six months), and with the repayment of the debenture, these costs were eliminated.

For accounting purposes, we have provided for the full amount of the agreement receivable from Enviro. We will, however, continue to vigorously pursue collection and take all actions available to recover the amounts outstanding. Any future recoveries will have a positive affect on our financial results.

Activity in the downstream sector of the petroleum industry, particularly in Eastern Canada, continued to improve during the second quarter, but the upstream sector, and activity in Western Canada, were sluggish. Completion and shipment of several large orders, scheduled for this second quarter, were delayed to October and gave our third quarter a good start.

Our current focus is the development and marketing of our tank lining technologies. We are working with suppliers and customers to assess new lining materials and processes. Our objective is to develop a product with superior quality and performance, as well as inherently safe installation techniques. We have also identified a number of other products to reach new markets. Products introduced in recent years, such as the domestic heating oil tank and Protektor and Pinnacle oilfield tanks, have gained market acceptance and are adding to our revenue and income.

We are also focusing on the improvement in the performance of our share price. This will be achieved through continued growth in revenue and income, together with an enhanced investor

communication program. The Toronto Stock Exchange accepted our notice to purchase up to five percent of the outstanding common shares under our normal course issuer bid. We commenced purchases during the second quarter, and, to date, 35,000 common shares have been repurchased for cancellation. We believe that our share price does not reflect the current value of your Company, and that this program is in the best interests of all shareholders.

While our second quarter did not match the robust growth experienced in the first quarter, the six-month period is on target to meet our overall growth objectives. 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 & Chief Executive Officer



Tony G. Barlott
Vice President Finance & Chief Financial Officer

November 12, 2003

Management's Discussion and Analysis

This discussion and analysis should be read in conjunction with the Company's March 31, 2003 audited annual consolidated financial statements and related notes, as well as Management's Discussion and Analysis contained in the 2003 Annual Report and the Message to Shareholders included in this Second Quarter Report.

Operating Results

The Company used the same accounting policies and methods as in the March 31, 2003 audited annual consolidated financial statements. 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 fiscal quarters have the highest levels of activity, corresponding to the seasonality of the installation of underground liquid storage systems in Canada.

Net income

Net income for the second quarter was \$97,000 (\$333,000 for six months) as compared to net income of \$737,000 in the second quarter (\$644,000 for six months) last year. The basic and diluted earnings per share for the second quarter were \$0.01 (\$0.02 for six months) as compared to \$0.05 per share (\$0.02 for six months) last year.

The decrease in the second quarter this year was largely due to the provision for impairment of the agreement receivable from ZCL Enviro Systems, Inc. ("Enviro"), as well as the small reduction in revenue. The \$880,000 provision for impairment (\$580,000 after tax) resulted in a reduction in net earnings of \$0.03 per share. Last year, convertible subordinated debenture ("debenture") costs, net of tax, of \$245,000 for the second quarter (\$461,000 for six months) were deducted in the calculation of earnings per share. The debenture was repaid in September 2002 and these costs have been eliminated.

Stock options and warrants are not included in the calculation of diluted shares as their exercise prices exceeded the average market share price for the periods. The debenture was not included in the calculation of diluted shares last year as the market share price was below the threshold conversion price of \$3.00.

Revenue

Revenue in the second quarter decreased by approximately 1.6% to \$7.9 million (increased by 16.5% to \$15.3 million for six months), from \$8.0 million (\$13.1 million for six months) last year. As described in Note 6, freight amounts billed to customers are recorded as revenue, rather than netted against freight costs which are recorded as part of manufacturing and selling costs.

Activity in the downstream sector of the petroleum industry, particularly in Eastern Canada, continued to improve during the second quarter, but the upstream sector, and activity in Western Canada, were sluggish. Completion and shipment of a number of large orders were delayed to early October of this year, and gave our third quarter a good start.

The development and marketing of the tank lining technologies continues to be a priority for the Company. Products introduced in recent years—domestic heating oil tanks, Protektor and Pinnacle oilfield tanks, filament wound pressure vessels, as well as custom storage and lining systems—continue to gain market acceptance and contribute to revenue.

Revenue less manufacturing and selling costs

Revenue less manufacturing and selling costs decreased to \$2.0 million, or 25.9% of revenue, in the second quarter (\$3.5 million, or 22.8% of revenue, for six months) from \$2.1 million, or 26.4% of revenue, in the quarter (\$3.0 million, or 22.6% of revenue, for six months) last year. Overall manufacturing margins and costs have been maintained at similar levels as last year, and efforts to further improve production processes and reduce costs are ongoing.

Amortization

Amortization was \$495,000 for the second quarter this year, and \$527,000 for the quarter last year; amortization increased to \$999,000 for the six months from \$964,000 last year. The increase from last year for the six-month period is due to the amortization of assets from the acquisition of Parabeam Industries BV ("Parabeam") (acquired in September 2002).

General and administration

General and administration expenses increased to \$409,000 for the second quarter this year (\$844,000 for six months) from \$373,000 for the quarter (\$781,000 for six months) last year. These costs have generally been maintained at the same levels as last year.

Provision for impairment of agreement receivable

As described in Note 2, Enviro has not made any payments under the agreement receivable since the fourth quarter of last year, 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 realization, cannot be estimated with reasonable reliability. Accordingly, during the quarter, a provision of \$880,000 was recorded for impairment of the agreement receivable. Although this allowance for impairment has been provided, all available courses of action will continue to be pursued to collect the balance of the receivable or otherwise realize upon security.

Financing charges

Financing charges for the second quarter were \$81,000 (\$195,000 for six months), as compared to \$78,000 for the quarter (\$181,000 for six months) last year. The level of long-term bank debt was higher this year as a result of the refinancing in September 2002. However, the corresponding much higher costs of the debenture, which was repaid at that time, were eliminated. Last year, financing charges relating to short-term indebtedness associated with the acquisition of Mocoat Services Incorporated ("Mocoat") were incurred.

Income taxes

The Company's tax rate is approximately the same as last year, and overall income taxes are affected by non-deductible expenses and the large corporations tax. Future income taxes relate primarily to the utilization of losses of prior years for tax purposes, and differences between financial reporting and tax bases of assets and liabilities.

Financial Position and Liquidity

Working capital increased to \$10.5 million at September 30, 2003 from \$8.7 million at March 31, 2003. Cash was \$2.3 million at September 30, 2003, as compared to cash of \$1.3 million at March 31, 2003. These increases were the result of the profitable operations during the period.

Due to the timing of cash receipts and payments during the period, cash of \$1.0 million was provided by operating activities in the second quarter (\$1.6 million for six months) this year, as compared to cash of \$206,000 used in operating activities in the second quarter (\$1.2 million provided by operating activities for six months) last year. Cash flows from financing activities last year reflected the \$7.0 million private placement of common shares and warrants to ARC Energy Venture Fund 3, the refinancing of bank term debt, and the repayment of the debenture. Cash flows from investing activities last year included the acquisitions of Mocoat and Parabeam.

Accounts receivable were \$6.1 million at September 30, 2003, approximately at the same level as March 31, 2003. The Company deals largely with major oil and gas companies in Canada. 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, 2003, two customers accounted for 22% (March 31, 2003 – one customer, 17%) of accounts receivable.

Inventories increased to \$6.0 million at September 30, 2003 from \$5.4 million at March 31, 2003. This is a normal seasonal build-up to meet the higher levels of activity in the third fiscal quarter. Due to the timing of purchases and payments, accounts payable and accrued liabilities increased to \$4.0 million at September 30, 2003 from \$3.9 million at March 31, 2003.

Shareholders' equity increased to \$19.4 million, as a result of net income for the period. At the Annual General and Special Meeting on August 18, 2003, shareholders passed a special resolution to eliminate the deficit at March 31, 2003 and reduce the stated capital of the Company. Contributed surplus was reduced by \$745,000, share capital by \$8.3 million, and accumulated deficit by \$9.0 million.

Management's Discussion and Analysis – continued

During the quarter, the Toronto Stock Exchange ("TSX") accepted notice of intention filed by the Company to make a normal course issuer bid ("NCIB"). During the twelve-month period commencing July 10, 2003 and ending July 9, 2004, the Company may purchase on the TSX up to a maximum of 885,846 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. The Company believes that 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.

During the second quarter, 1,000 common shares (2002 – nil) were repurchased for cancellation pursuant to the NCIB at a cost of \$680 (2002 – \$nil). This repurchase resulted in the reduction of share capital of \$1,545 and an increase in contributed surplus of \$865.

Consolidated Financial Statements



Consolidated Balance Sheets

(Unaudited)

(in thousands of dollars)	September 30 2003 \$	March 31 2003 \$
Assets		
Current		
Cash	2,276	1,333
Accounts receivable	6,130	6,104
Inventories	5,990	5,379
Prepaid expenses	491	115
Future tax assets	421	421
	15,308	13,352
Agreement receivable (note 2)		880
Capital assets	7,886	7,981
Deferred costs	1,108	1,579
Intangible assets	1,536	1,748
Goodwill	1,926	1,926
Future tax assets	320	548
	28,084	28,014
Liabilities and Shareholders' Equity		
Current		
Accounts payable and accrued liabilities	3,988	3,870
Income taxes payable	72	82
Current portion of long-term debt	714	714
Future tax liabilities	16	17
	4,790	4,683
Long-term debt	3,571	3,929
Government grants	165	169
Future tax liabilities	146	153
	8,672	8,934
Shareholders' equity		
Share capital (note 3)	19,078	27,378
Contributed surplus (note 3)	1	745
Retained earnings (deficit) (note 3)	333	(9,043)
	19,412	19,080
	28,084	28,014

See accompanying notes

Consolidated Statements of Income and Retained Earnings (Deficit)

(Unaudited)

Periods ended September 30	Three months		Six months	
	2003	2002	2003	2002
(in thousands of dollars, except per share amounts)	\$	\$	\$	\$
Revenue	7,896	8,027	15,305	13,135
Manufacturing and selling costs	5,853	5,904	11,823	10,164
	2,043	2,123	3,482	2,971
Amortization	495	527	999	964
General and administration	409	373	844	781
Provision for impairment of agreement receivable (note 2)	880		880	
Operating income	259	1,223	759	1,226
Financing charges	81	78	195	181
Income before income taxes	178	1,145	564	1,045
Income taxes				
Current	6	8	11	16
Future	75	400	220	385
	81	408	231	401
Net income for the period	97	737	333	644
Deficit, beginning of the period	(8,807)	(9,285)	(9,043)	(8,976)
Common share issue costs, net of tax		(362)		(362)
Convertible subordinated debenture costs, net of tax		(245)		(461)
Reduction of stated capital (note 3)	9,043		9,043	
Retained earnings (deficit), end of the period	333	(9,155)	333	(9,155)
Basic and diluted earnings per share (note 5)	\$0.01	\$0.05	\$0.02	\$0.02

See accompanying notes

Consolidated Statements of Cash Flows

(Unaudited)

Periods ended September 30

	Three months		Six months	
	2003	2002	2003	2002
(in thousands of dollars)	\$	\$	\$	\$
Cash Flows from Operating Activities				
Cash receipts from customers	7,585	5,595	15,359	12,129
Cash paid to suppliers and employees	(6,421)	(5,692)	(13,616)	(10,730)
Interest paid	(122)	(91)	(149)	(190)
Income taxes paid	(14)	(18)	(21)	(24)
	1,028	(206)	1,573	1,185
Cash Flows from Financing Activities				
Loans from (repayments to) directors		(550)		
Issue of long-term debt		5,000		5,000
Finance costs		(139)		(139)
Repayment of long-term debt	(179)	(2,706)	(358)	(2,889)
Repurchase of shares for cancellation (note 3)	(1)		(1)	
Issue of common shares and warrants		7,000		7,000
Common share issue costs		(528)		(528)
Repayment of convertible subordinated debenture		(7,985)		(8,185)
Convertible subordinated debenture costs		(208)		(348)
	(180)	(116)	(359)	(89)
Cash Flows from Investing Activities				
Collection of agreement receivable		108		276
Business acquisitions, including bank indebtedness assumed		(838)		(1,251)
Purchase of capital assets	(129)	(37)	(271)	(178)
Product development costs deferred				(4)
	(129)	(767)	(271)	(1,157)
Increase (decrease) in cash	719	(1,089)	943	(61)
Cash, beginning of the period	1,557	1,219	1,333	191
Cash, end of the period	2,276	130	2,276	130

See accompanying notes

Notes to Consolidated Financial Statements

(Unaudited)

September 30, 2003 and 2002

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, 2003. 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. Agreement Receivable

ZCL Enviro Systems, Inc. ("Enviro") has not made any payments under the agreement receivable since the fourth fiscal quarter of last year, 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, cannot be estimated with reasonable reliability. Accordingly, during the quarter, a provision of \$880,000 was recorded for impairment of the agreement receivable.

Although this allowance for impairment has been provided, all available courses of action will continue to be pursued to collect the balance of the receivable or otherwise realize upon security. As collateral for the agreement receivable, the Company is entitled to the return of its 40% interest in Enviro, which is incorporated under the laws of the Philippines and manufactures products under a long-term license agreement utilizing the Company's technology.

3. Share Capital

During the period, 1,000 common shares (2002 – nil) were repurchased for cancellation pursuant to a normal course issuer bid at a cost of \$680 (2002 – \$nil). This repurchase resulted in the reduction of share capital of \$1,545 and increase in contributed surplus of \$865.

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

4. Stock-Based Compensation

The fair value of stock options and warrants are determined, at the date of grant, 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, of the options and warrants granted to employees after April 1, 2002, in accordance with the fair value method of accounting for stock-based compensation:

Periods ended September 30 (in thousands of dollars, except earnings per share)	Three months		Six months	
	2003	2002	2003	2002
	\$	\$	\$	\$
Net income for the period	97	737	333	644
Compensation expense	57	2	113	2
Pro-forma net income for the period	40	735	220	642
Earnings per share:				
Reported basic and diluted earnings per share	0.01	0.05	0.02	0.02
Compensation expense per share	0.01	0.00	0.01	0.00
Pro-forma basic and diluted earnings per share	0.00	0.05	0.01	0.02

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

Notes to Consolidated Financial Statements – continued

	September 30, 2003	September 30, 2002
Fair value of options (\$)	0.37	0.37
Fair value of warrants (\$)	0.36	0.38
Risk-free interest rate (%)	4.02	4.00
Expected hold period to exercise (years)	options 4.0 / warrants 4.9	options 4.0 / warrants 5.0
Volatility in the price of the Company's shares (%)	options 61.6 / warrants 56.6	options 61.6 / warrants 56.2
Dividend yield (%)	0.00	0.00

5. Earnings Per Share

Reconciliations for purposes of the determination of the basic and diluted per share computations are as follows:

Periods ended September 30	Three months		Six months	
(in thousands of dollars, except shares)	2003	2002	2003	2002
	\$	\$	\$	\$
Net income for the period	97	737	333	644
Convertible subordinated debenture costs, net of tax		245		461
Net income available to common shareholders	97	492	333	183
	#	#	#	#
Weighted average number of shares outstanding – basic and diluted	17,716,083	10,525,322	17,716,499	10,216,983
Shares outstanding, end of the period	17,715,920	17,573,378	17,715,920	17,573,378

Share options and warrants are not included in the calculation of diluted shares as their exercise prices exceed the average market share price for the periods.

The convertible subordinated debenture is not included in the calculation of diluted shares in 2002 as the market share price was below the threshold conversion price of \$3.00.

6. Comparative Figures

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the current period's consolidated financial statements.

In the current period, freight amounts billed to customers are recorded as revenue, rather than netted against freight costs which are recorded as part of manufacturing and selling costs. Accordingly, freight billed to customers of \$272,000 (2002 – \$289,000) for the second quarter, and \$470,000 (2002 – \$496,000) for the six-month period, is included in revenue.

Board of Directors

James S. Edwards, Chairman of the Board
Venence G. Côté, President and CEO, Director
Fred Dymment, Director
Roderick W. Graham, Director
Simon Sochatsky, Director

Transfer Agent and Registrar

Computershare Trust Company of Canada
Calgary, Alberta

Auditors

Ernst & Young LLP
Edmonton, Alberta

General Counsel

Parlee McLaws LLP
Edmonton, Alberta

Investor Relations

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Stock Listing and Share Symbol

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