Environment Focus Innovation

ZCL Composites Inc
Second Quarter Report 2006

ZCL COMPOSITES INC.

Message to Shareholders

The outlook for our economical and environmentally-friendly products continues to be very positive, driven by new market trends and entrants as well as increasingly stringent industry standards and government legislation, such as double containment of underground storage of hazardous liquids and ethanol and other blends of fuels being legislated in various parts of Canada and USA. While activity in the petroleum industry and other traditional markets of the Company remains very strong, revenue from the downstream sector of the petroleum industry was down as the result of the deferral of upgrade and new installation projects in the second quarter. This reduction offset increases in other market sectors and revenue from Triple M Fiberglass Mfg. Ltd. that was acquired in April 2005. Accordingly, revenue for the second quarter increased by 1.4% to a record $11.2 million from $11.0 million for the quarter last year, and increased by 12.3% to $19.5 million for the six-month period from $17.3 million for the six-month period last year. With our expanding order backlog and the strong start to the third quarter, we remain confident that we can achieve our target of annual revenue growth of 15% to 20% coupled with a corresponding increase in income.

Net income for the second quarter decreased to $820,000 from $1.2 million last year, and to $1.1 million for the six-month period from $1.3 million last year. Basic earnings per share for the second quarter were $0.05 as compared to $0.07 last year, and $0.06 for the six-month period as compared to $0.07 last year. Diluted earnings per share for the second quarter were $0.04 as compared to $0.07 last year, and $0.05 for the six-month period as compared to $0.07 last year.

Notwithstanding the higher revenue during the period, net income decreased this year largely because of lower overall margins, as a result of increased raw material prices as well as the reduced level of higher margin downstream products, along with increased expenses for marketing and sales activities related to home heating oil and tank lining products. We expect to be able to maintain or improve our margins for the balance of this fiscal year through selling price increases.

We continue to focus on the final testing and marketing of our tank lining technologies and the marketing of home heating oil tanks. The lining program is progressing as planned and we completed the second field test in the second quarter. We are now proceeding with evaluation and testing with respect to obtaining Underwriters' Laboratories of Canada ("ULC") and Underwriters' Laboratories ("UL") listings in accordance with recognized industry standards. Our lining system marketing program will be launched at the Petroleum Equipment Institute Convention in Las Vegas, Nevada on November 16 – 18, 2005. We anticipate that this new product will start to contribute to our revenue in the latter part of this fiscal year.

Following the UL approval of our home heating oil tanks for the USA market last year, we are marketing and selling these tanks in the New England states as well as Eastern Canada. Approximately 8 million households in North America use heating or furnace oil to heat their homes, and our plan is to systematically achieve a significant share of this market over the next five years.

During the quarter, we were pleased to pay our second annual dividend of $0.08 per common share that was declared in June. This dividend, which was an increase of $0.02 or 33% over last year's dividend, was set by your Board of Directors with consideration of our strong results, cash flow and financial position, and the anticipated cash required to continue our strategic growth plan.

We remain committed to our strategy of profitable growth and are on target to meet our annual growth objective. With the ongoing support of our dedicated customers, employees and shareholders, we will continue to deliver quality products and build value for our shareholders.

Venence G. Côté
President and Chief Executive Officer

November 4, 2005

Management's Discussion and Analysis

November 4, 2005

The following discussion and analysis of the results of operations and cash flows for the period ended September 30, 2005, and the financial position as at September 30, 2005, should be read in conjunction with the Company's unaudited consolidated financial statements and related notes for the period ended September 30, 2005, the Management's Discussion and Analysis and audited consolidated financial statements and related notes for the year ended March 31, 2005, 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, 2005. 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, 2005 as it used in the audited annual consolidated financial statements for the year ended March 31, 2005. The consolidated statements of income and retained earnings 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 higher levels of activity, corresponding to the seasonality of the installation of underground liquid storage systems in Canada.

Revenue for the second quarter increased by 1.4% to a record $11.2 million from $11.0 million for the quarter last year, and increased by 12.3% to $19.5 million for the six-month period from $17.3 million for the six-month period last year. Net income for the second quarter decreased to $820,000 from $1.2 million for the quarter last year, and decreased to $1.1 million for the six-month period from $1.3 million last year. Basic earnings per share for the second quarter were $0.05 as compared to $0.07 last year, and $0.06 for the six-month period as compared to $0.07 for the period last year. Diluted earnings per share for the second quarter were $0.04 as compared to $0.07 last year, and $0.05 for the six-month period as compared to $0.07 for the period last year.

The overall increase in revenue was primarily due to the acquisition of Triple M Fiberglass Mfg. Ltd. ("Triple M") in April 2005, offset by decreased revenue from the downstream sector of the petroleum industry as a result of the deferral of upgrade and new installation projects in the second quarter. Nonetheless, the outlook for this market sector, as well as other traditional markets of the Company, remains very positive for the second half of this fiscal year. The order backlog is very strong and the third quarter is off to a good start. Inventories have been maintained at higher levels to meet orders and deliveries.

Notwithstanding the higher revenue during the period, the decrease in net income in the second quarter and six-month period this year was largely due to lower overall margins, as a result of increased raw material prices as well as the reduced level of higher margin downstream products, and increased expenses for marketing and sales activities related to home heating oil and tank lining products. Amortization decreased this year as certain deferred costs were fully amortized in the third quarter last year. Financing charges were higher this year because of increased utilization of the bank operating lines of credit and foreign exchange losses.

Cash flows from operating activities were $356,000 during the second quarter ($793,000 for the six-month period) this year, after the payment of income taxes of $412,000 in the quarter ($1.6 million in the six-month period), compared to $202,000 of cash used in operating activities during the quarter ($730,000 for the six-month period) last year. This increase was largely due to the timing of sales and collection of accounts receivable, the level of operations and the acquisition of Triple M during the period. The second annual dividend of $0.08 (2004 – $0.06) per common share was declared in the first quarter this year and dividends of $1.4 million (2004 - $1.1 million) were paid in the second quarter. The shares of Triple M, including bank indebtedness assumed, were acquired for cash of $2.6 million in the first quarter this year, and the business assets of Durex Steel & Alloy Industries Ltd. ("Durex") were purchased for cash of $1.2 million in the first quarter last year.

The effect of dilutive share options and warrants on the weighted-average shares outstanding was 2,263,809 shares (2004 – 1,145,718) for the second quarter and 2,261,625 (2004 – 1,037,155) for the six-month period. Two-thirds of the outstanding warrants vested last fiscal year. The remaining warrants were not included in the calculation of diluted shares this year as the market price was below the performance threshold. Last year, certain share options and warrants were not included in the calculation of diluted shares as the market price was below the exercise prices or the performance vesting thresholds.

In December 2004, a portion of the Company's manufacturing plant in Waverley, Nova Scotia was destroyed in an electrical fire. This facility produces primarily home heating oil tank products. Manufacturing resumed in the fourth quarter of last year and the plant has been fully restored. It is anticipated that insurance proceeds from the Company's insurers (subject to a $25,000 deductible under the insurance policy) will cover all damages. Accounts receivable at September 30, 2005 included $337,000 (March 31, 2005 - $590,000) related to the insurance claim, of which $47,000 has been collected subsequent to the end of the quarter.

The Company continues to focus on the marketing of home heating oil tanks and the final testing and marketing of its tank lining technologies. Marketing and sales of home heating oil tanks commenced in the New England states in the latter part of last fiscal year, following the Underwriters' Laboratories ("UL") approval of these tanks for the USA market. Heating or furnace oil is used for heating in about 8 million households in North America, largely in Eastern Canada and North-Eastern USA. The Company's objective is to systematically achieve a significant market share over the next five years.

Tank lining development costs of $394,000 (2004 - $97,000) during the second quarter and $572,000 (2004 – $232,000) in the six-month period were deferred. While the overall level of development costs has exceeded the initial estimated amount, the development program is progressing as planned and the second field test of the lining product was completed in the second quarter. Evaluation and testing is currently proceeding with respect to obtaining Underwriters' Laboratories of Canada ("ULC") and UL listings in accordance with recognized industry standards. This new product is expected to add to revenue in the latter part of fiscal 2006. Lining systems will be cautiously introduced to the marketplace and the lining program will be ramped up as field experience is gained and qualified applicators are trained in all aspects of this new system.

RESULTS OF OPERATIONS

Period Ended September 30, 2005 Compared to the Period Ended September 30, 2004

Revenue

Revenue for the second quarter increased by 1.4% to a record $11.2 million from $11.0 million for the quarter last year, and increased by 12.3% to $19.5 million for the six-month period from $17.3 million for the six-month period last year. The overall increase in revenue was primarily due to the acquisition of Triple M in April 2005, offset by decreased revenue from the downstream sector of the petroleum industry as a result of the deferral of upgrade and new installation projects in the second quarter. Nonetheless, the outlook for this market sector, as well as other traditional markets of the Company, remains very positive for the second half of this fiscal year. The order backlog is very strong and the third quarter is off to a good start. Inventories have been maintained at higher levels to meet orders and deliveries.

Products introduced in recent years – home 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 add to revenue.

Revenue less manufacturing and selling costs

Revenue less manufacturing and selling costs decreased to $2.2 million (19.9% of revenue) from $2.9 million (25.9% of revenue) in the second quarter last year, and to $3.5 million (18.2% of revenue) from $3.9 million (22.5% of revenue) for the six-month period last year. 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.

Notwithstanding the higher revenue during the period, the decrease in revenue less manufacturing and selling costs in the second quarter and six-month period this year was largely due to lower overall margins, as a result of increased raw material prices as well as the reduced level of higher margin downstream products, and increased expenses for marketing and sales activities related to home heating oil and tank lining products. Margins for the balance of this fiscal year are expected to be maintained or increased through selling price increases.

Amortization

Amortization decreased by $107,000 to $370,000 for the second quarter from $477,000 last year, and decreased by $212,000 to $733,000 for the six-month period from $945,000 last year. The overall level of amortization has decreased due to the deferred costs related to the acquisition of the assets of ZCL-USA, Inc. being fully amortized last year, partially offset by an increase in amortization with the acquisitions of Triple M and Durex.

Additional lining development costs were deferred during the first and second quarters. These development costs will be amortized upon the commencement of commercial production of the lining products.

General and administration

General and administration expenses were $490,000 or 4.4% of revenue (2004 - $494,000 or 4.5% of revenue) for the second quarter, and $952,000 or 4.9% of revenue (2004- $923,000 or 5.3% of revenue) for the six-month period. These costs have generally been maintained at the same levels as last year, but are increasing as the Company grows and processes are put in place relating to the requirements of current corporate governance developments.

Financing charges

Financing charges for the second quarter were $94,000 ($163,000 for the six-month period), up from $40,000 for the quarter ($43,000 for the six-month period) last year. The increase is the result of the higher utilization of the operating lines of credit (bank indebtedness), as well as foreign exchange losses related to the translation of transactions denominated in foreign currencies and the accounts of Parabeam Industries B.V.

Income taxes

The Company's overall effective tax rate was 35.4% in the second quarter (36.8% for the six-month period), as compared to 33.4% for the quarter (34.4% for the six-month period) last year. The Company's statutory income tax rate is approximately the same as last year; the increase in the effective rate was due to non-deductible expenses, including stock-based compensation, that are not significant but had a larger effect this year because of the lower level of pre-tax income.

The Company was in a taxable position in the latter part of last year and in the first and second quarters this year. Tax losses of prior years have been utilized. Future tax liabilities largely represent the carrying value of assets in excess of their tax bases.

SUMMARY OF QUARTERLY RESULTS

The following selected information for the eight most recent quarters should be read in conjunction with the applicable interim unaudited and annual audited consolidated financial statements and accompanying notes.

Quarterly Unaudited Results
(in thousands of dollars, except per share amounts)

	Sep 30/05	Jun 30/05	Mar 31/05	Dec 31/04
Revenue	11,173	8,287	10,372	11,056
Net income	820	244	1,151	1,028
Basic earnings per share	$0.05	$0.01	$0.07	$0.06
Diluted earnings per share	$0.04	$0.01	$0.06	$0.05

	Sep 30/04	Jun 30/04	Mar 31/04	Dec 31/03
Revenue	11,020	6,308	7,901	10,726
Net income	1,229	72	485	1,134
Basic earnings per share	$0.07	$0.00	$0.03	$0.06
Diluted earnings per share	$0.07	$0.00	$0.03	$0.06

Historically, the second and third fiscal quarters generally have the higher levels of activity, corresponding to the seasonality of the installation of underground liquid storage systems in Canada. This seasonality is expected to continue, but may diminish as the Company expands its product lines into new markets that have different seasonality or that are less influenced by the effect of weather in the timing of installation.

LIQUIDITY AND CAPITAL RESOURCES

Working capital (current assets less current liabilities) at September 30, 2005 was $11.2 million, as compared to $12.9 million at March 31, 2005. Current assets decreased by $911,000 and current liabilities increased by $822,000. These changes reflect the operations, dividends paid and cash acquisition of Triple M during the period.

At September 30, 2005, accounts receivable decreased by $1.6 million from March 31, 2005 to $9.7 million, inventories increased by $2.6 million to $9.7 million, accounts payable and accrued liabilities decreased by $771,000 to $5.6 million, and income taxes changed by $1.4 million from a payable of $1.3 million to a recoverable of $26,000. These changes reflect the continued strong level of operations, acquisition of Triple M, and payment of income taxes during the period. Inventories have been maintained at higher levels to meet the robust activity anticipated in the third quarter of this fiscal year.

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, 2005, the four largest customers accounted for approximately 21% (March 31, 2005 – two customers, 22%) of accounts receivable.

Cash Flows

Cash flows from operating activities were $356,000 during the second quarter ($793,000 for the six-month period) this year, after the payment of income taxes of $412,000 in the quarter ($1.6 million in the six-month period), compared to $202,000 of cash used in operating activities during the quarter ($730,000 for the six-month period) last year. This increase was largely due to the timing of sales and collection of accounts receivable, the level of operations and the acquisition of Triple M during the period.

As a result of the decrease in cash during the period, net advances on the revolving operating lines of credit (bank indebtedness) were $1.6 million (2004 – $1.2 million) during the second quarter and $2.8 million (2004 - $1.3 million) during the six-month period. The Company has operating lines of credit of $10.3 million provided by a chartered bank.

The shares of Triple M were acquired for cash of $2.6 million, including bank indebtedness assumed, in the first quarter this year, and the business assets of Durex were purchased for cash of $1.2 million in the first quarter last year. Product development costs, related to lining materials and processes, of $394,000 (2004 – $97,000) in the second quarter, and $572,000 (2004 – $232,000) in the six-month period, were deferred. Property, plant and equipment additions were $177,000 (2004 – $89,000) in the second quarter and $466,000 (2004 – $228,000) in the six-month period; these additions related largely to the purchase of equipment for tank lining and to increase production capacity and efficiency, and the upgrade of computer and other office equipment.

Summary of Cash Flows **Periods ended September 30** (in thousands of dollars)	**Three months** **2005** **$**	 2004 $	**Six months** **2005** **$**	 2004 $
Operating activities	**356**	(202)	**793**	(730)
Financing activities	**215**	388	**1,459**	503
Investing activities	**(571)**	(186)	**(3,635)**	(1,653)
Decrease in cash	**–**	–	**(1,383)**	(1,880)
Cash, beginning of the period	**–**	–	**1,383**	1,880
Cash, end of the period	**–**	–	**–**	–

The normal course issuer bid filed by the Company in August 2004 expired on August 18, 2005 with no shares being purchased. In August 2005, the Toronto Stock Exchange ("TSX") accepted notice of another normal course issuer bid ("2005 NCIB") filed by the Company. For the twelve-month period from August 25, 2005 and ending August 24, 2006, the Company may purchase on the TSX up to a maximum of 899,210 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, the price for any such shares will be the market price at the time, and all such shares purchased will be cancelled. No shares have been purchased pursuant to the 2005 NCIB.

Contractual Obligations

In addition to the operating lease commitments disclosed in the audited March 31, 2005 consolidated financial statements, the minimum rental under the terms of the operating lease for the premises of Triple M, leased as part of the acquisition in the first quarter this year, is $182,000 per year for a period of five years to March 31, 2010.

TRANSACTIONS WITH RELATED PARTIES

The related party transactions are described in note 7 to the unaudited consolidated financial statements for the period ended September 30, 2005. 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, 2005 Annual Report.

OTHER

Outstanding Share Data

As at November 4, 2005, there were 17,992,218 common shares, 1,127,401 share options and 3,430,912 warrants outstanding.

Consolidated Balance Sheets

(unaudited)

(in thousands of dollars)	September 30 2005 $	March 31 2005 $
Assets		
Current		
Cash	–	1,383
Accounts receivable	**9,732**	11,294
Income taxes recoverable	**26**	–
Inventories	**9,675**	7,120
Prepaid expenses	**251**	548
Future tax assets	–	250
	19,684	20,595
Property, plant and equipment	**9,958**	8,246
Deferred costs *[note 3]*	**1,270**	707
Intangible assets	**942**	1,085
Goodwill	**1,991**	1,991
	33,845	32,624
Liabilities and Shareholders' Equity		
Current		
Bank indebtedness *[note 4]*	**2,843**	–
Accounts payable and accrued liabilities	**5,566**	6,337
Income taxes payable	–	1,336
Future tax liabilities	**110**	24
	8,519	7,697
Government grants	**147**	151
Future tax liabilities	**1,584**	947
	10,250	8,795
Shareholders' equity		
Share capital *[note 5a]*	**19,331**	19,277
Contributed surplus *[note 5a]*	**257**	171
Retained earnings	**4,007**	4,381
	23,595	23,829
	33,845	32,624

See accompanying notes

Consolidated Statements of Income and Retained Earnings

(unaudited)

Periods ended September 30	**Three months**		**Six months**	
	2005	**2004**	**2005**	**2004**
(in thousands of dollars, except per share amounts)	**$**	**$**	**$**	**$**
Revenue	**11,173**	11,020	**19,460**	17,328
Manufacturing and selling costs *[notes 6a and 7]*	**8,949**	8,164	**15,928**	13,435
	2,224	2,856	**3,532**	3,893
Amortization *[note 3]*	**370**	477	**733**	945
General and administration *[note 6a]*	**490**	494	**952**	923
Financing charges *[note 8]*	**94**	40	**163**	43
Income before income taxes	**1,270**	1,845	**1,684**	1,982
Income taxes				
Current	**115**	346	**215**	351
Future	**335**	270	**405**	330
	450	616	**620**	681
Net Income for the period	**820**	1,229	**1,064**	1,301
Retained earnings, beginning of the period	**3,187**	973	**4,381**	1,952
Dividends *[note 5b]*	**–**	–	**(1,438)**	(1,051)
Retained earnings, end of the period	**4,007**	2,202	**4,007**	2,202
Basic earnings per share *[note 9]*	**$0.05**	$0.07	**$0.06**	$0.07
Diluted earnings per share *[note 9]*	**$0.04**	$0.07	**$0.05**	$0.07

See accompanying notes

Consolidated Statements of Cash Flows
(unaudited)

Periods ended September 30	Three months		Six months	
	2005	**2004**	**2005**	**2004**
(in thousands of dollars)	**$**	**$**	**$**	**$**
Cash Flows from Operating Activities				
Cash receipts from customers	**9,166**	7,924	**22,226**	14,917
Cash paid to suppliers and employees	**(8,317)**	(8,088)	**(19,707)**	(15,599)
Interest paid	**(81)**	(33)	**(149)**	(36)
Income taxes paid	**(412)**	(5)	**(1,577)**	(12)
	356	(202)	**793**	(730)
Cash Flows from Financing Activities				
Net advances on bank indebtedness *[note 4]*	**1,643**	1,213	**2,843**	1,328
Issue of common shares *[note 5a]*	**10**	226	**54**	226
Dividends *[note 5b]*	**(1,438)**	(1,051)	**(1,438)**	(1,051)
	215	388	**1,459**	503
Cash Flows from Investing Activities				
Business acquisition, including bank indebtedness assumed *[note 2]*	**–**	–	**(2,597)**	(1,193)
Purchase of property, plant and equipment	**(177)**	(89)	**(466)**	(228)
Deferred development costs *[note 3]*	**(394)**	(97)	**(572)**	(232)
	(571)	(186)	**(3,635)**	(1,653)
Decrease in cash	**–**	–	**(1,383)**	(1,880)
Cash, beginning of the period	**–**	–	**1,383**	1,880
Cash, end of the period	**–**	–	**–**	–

See accompanying notes

Notes to Consolidated Financial Statements

September 30, 2005 and 2004 (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, 2005. 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 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 higher levels of activity, corresponding to the seasonality of the installation of underground liquid storage systems in Canada.

2. Business Acquisitions

a) Fiscal 2006

Effective April 1, 2005, the Company acquired 100% of the shares of Triple M Fiberglass Mfg. Ltd. (Triple M) located in Edmonton Alberta. Triple M manufactures fiberglass underground and aboveground tanks, vessels, pipe and other custom environmental products.

The acquisition was accounted for using the purchase method and the consolidated financial statements include the results of operations from April 1, 2005. Cash consideration for the purchase was $2,000,000, including acquisition costs. The fair value of the net assets acquired and liabilities assumed was as follows:

(in thousands of dollars)	$
Bank indebtedness assumed	(597)
Non-cash working capital	1,330
Property, plant and equipment	1,720
Non-contractual customer relationships	75
Customer order backlog	20
Product certification and safety marks	20
Future tax liabilities	(568)
Net assets acquired	**2,000**

Amortization of non-contractual customer relationships is computed using the straight-line method over three years. Amortization of customer order backlog is computed using the straight-line method over six months. Product certification and safety marks are indefinite life assets and are not subject to amortization.

The minimum rental under the terms of the operating lease for the premises of Triple M is $182,000 per year for a period of five years to March 31, 2010.

b) Fiscal 2005

Effective May 7, 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, 2005 and March 31, 2005 is comprised of deferred development costs and includes $394,000 (2004 - $97,000) of development costs incurred during the second quarter and $572,000 (2004 - $232,000) incurred during the six-month period. These costs incurred related to development projects in process at September 30, 2005 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	**Three months**		**Six months**	
	2005	**2004**	**2005**	**2004**
(in thousands of dollars)	**$**	**$**	**$**	**$**
Property, plant and equipment	**238**	198	**470**	388
Deferred development costs	**4**	171	**9**	343
Intangible assets	**130**	110	**258**	218
Government grants	**(2)**	(2)	**(4)**	(4)
	370	477	**733**	945

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% (4.75%; March 31, 2005 – 4.50%). 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 and Contributed Surplus

a) Share capital and contributed surplus

Issued and outstanding

	Share Capital				**Contributed Surplus**	
	2005		**2004**		**2005**	**2004**
	Shares		**Shares**			
(in thousands of dollars, except shares)	**#**	**$**	**#**	**$**	**$**	**$**
Balance, as at March 31	**17,943,919**	**19,277**	17,511,320	18,853	**171**	77
Share options exercised for cash	**25,333**	**33**	–	–	**–**	–
Warrants exercised for cash	**11,633**	**11**	–	–	**–**	–
Stock-based compensation	**–**	**–**	–	–	**35**	15
Balance, as at June 30	**17,980,885**	**19,321**	17,511,320	18,853	**206**	92
Share options exercised for cash	**8,000**	**7**	102,600	98	**–**	–
Warrants exercised for cash	**3,333**	**3**	135,000	128	**–**	–
Stock-based compensation	**–**	**–**	–	–	**51**	29
Balance, as at September 30	**17,992,218**	**19,331**	17,748,920	19,079	**257**	121

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.

b) Dividends

On June 15, 2005, an annual dividend of $0.08 (2004 - $0.06) per common share was declared for all shareholders of record on July 14, 2005. The dividends of $1,438,000 (2004 - $1,051,000) were paid on August 4, 2005.

c) Share options and warrants

	2005		**2004**	
	Share options	**Warrants**	**Share options**	**Warrants**
	#	**#**	**#**	**#**
Balance, as at March 31	**1,160,734**	**3,445,878**	1,145,000	3,684,211
Granted	**–**	**–**	260,000	–
Exercised	**(25,333)**	**(11,633)**	–	–
Balance, as at June 30	**1,135,401**	**3,434,245**	1,405,000	3,684,211
Exercised	**(8,000)**	**(3,333)**	(102,600)	(135,000)
Balance, as at September 30	**1,127,401**	**3,430,912**	1,302,400	3,549,211

6. Stock-Based Compensation

The Black-Scholes model, used by the Company to calculate the values of options and warrants, as well as certain 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.

a) 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 this year, no share options were granted (2004 – granted 260,000 options with exercise prices at the market share price on the grant date), and 137,106 (2004 – 230,000) warrants were transferred to employees with exercise prices below the market share price on the transfer date. Stock-based compensation expense of $51,000 (2004 - $25,000) in the second quarter and $86,000 (2004 - $36,000) in the six-month period was recorded in manufacturing and selling costs and general and administration in the consolidated 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 in Excess of Market	Granted at Market	Transferred in Excess of Market	Transferred Below Market
Weighted-average fair value	$0.29	$0.65	$0.18	$1.02
Risk-free interest rate (%)	3.89	3.77	4.37	3.45
Expected hold period to exercise (years)	4.0	4.0	4.5	3.0
Volatility in the price of the Company's shares (%)	60.8	55.5	60.5	53.1
Dividend yield (%)	0.00	0.00	0.00	0.92

In accordance with the fair value method of accounting for stock-based compensation for non-employees, nil (2004 - $4,000) in the second quarter and nil (2004 - $8,000) in the six-month period was recorded as general and administration expense in the consolidated statements of income.

b) 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:

Periods ended September 30	**Three months**		**Six months**	
	2005	**2004**	**2005**	**2004**
(in thousands of dollars, except earnings per share)	$	$	$	$
Net income for the period	**820**	1,229	**1,064**	1,301
Stock-based compensation expense	**51**	49	**104**	103
Pro-forma net income for the period	**769**	1,180	**960**	1,198
Earnings per share:				
Reported basic earnings per share	**0.05**	0.07	**0.06**	0.07
Compensation expense per share	**0.01**	0.00	**0.01**	0.01
Pro-forma basic earnings per share	**0.04**	0.07	**0.05**	0.06
Reported diluted earnings per share	**0.04**	0.07	**0.05**	0.07
Compensation expense per share	**0.00**	0.00	**0.00**	0.01
Pro-forma diluted earnings per share	**0.04**	0.07	**0.05**	0.06

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 (%)	0.0	0.0

7. Related Party Transactions

Trucking services of $101,000 (2004 - $94,000) for the second quarter and $187,000 (2004 - $175,000) for the six-month period, included in manufacturing and selling costs in the consolidated statements of income, were provided by a corporation controlled by a director of the Company. Accounts payable and accrued liabilities at September 30, 2005 included $18,000 (March 31, 2005 - $6,000) owing to the corporation. Normal commercial rates were paid for these services.

8. Financing Charges

Periods ended September 30	Three months		Six months	
	2005	2004	2005	2004
(in thousands of dollars)	$	$	$	$
Interest, short term	**60**	26	**91**	34
Foreign exchange losses	**34**	14	**72**	9
	94	40	**163**	43

9. 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	
	2005	2004	2005	2004
(in thousands of dollars, except number of shares)	$	$	$	$
Numerator:				
Net income available to common shareholders	**820**	1,229	**1,064**	1,301
Denominator:				
Weighted-average shares outstanding - basic	**17,986,552**	17,568,137	**17,968,180**	17,539,884
Effect of dilutive securities				
Share options	**723,313**	565,324	**716,969**	**512,391**
Warrants	**1,540,496**	580,394	**1,544,656**	**524,764**
Weighted-average shares outstanding - diluted	**20,250,361**	18,713,855	**20,229,805**	18,577,039

In 2005, certain of the warrants were not included in the calculation of diluted shares as the market price was below the performance vesting threshold. In 2004, certain share options were not included in the calculation of diluted shares as their exercise prices, plus the amount of compensation cost attributed to future service and not yet recognized, exceeded the average market share price, and certain of the warrants were not included as the market price was below the performance vesting thresholds.

10. Derivative Financial Instruments

At September 30, 2004, the Company had entered into foreign currency collar arrangements not accounted for as hedges (September 30, 2005 – nil). These arrangements provided for the purchase of euros, up to a total Canadian dollar equivalent of $265,000, at a rate of $1.566 per euro. The fair values of these arrangements, estimated using market rates at September 30, 2004, were nil. During the three-month and six-month periods in 2004, net realized and unrealized losses of less than $1,000 related 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. Dyment, Director

Nancy L. Smith, Director

Simon Sochatsky, Director

Corporate Office

6907 - 36 Street

Edmonton, Alberta

Canada T6B 2Z6

Common Shares Outstanding

as of November 4, 2005

Total Outstanding: 17,992,218

Investor Relations

Copies of this Quarterly Report

may be obtained by calling,

Investor Relations at 780-466-6648

or email IR@zcl.com

Transfer Agent & Registrar

Olympia Trust Company

#2300, 125 - 9th Avenue S.W.

Calgary, Alberta

T2G 0P6

Auditors

Ernst & Young LLP

1801 Scotia 2

Scotia Place

10060 Jasper Avenue

Edmonton, Alberta

T5J 3R8

General Counsel

Parlee McLaws LLP

Suite 1500, Manulife Place

10180 - 101 Street

Edmonton, Alberta

T5J 4K1

Stock Listing and Share Symbol

Toronto Stock Exchange: ZCL

ZCL
COMPOSITES INC.

6907 – 36 Street,
Edmonton, Alberta T6B 2Z6
1 800 661-8265