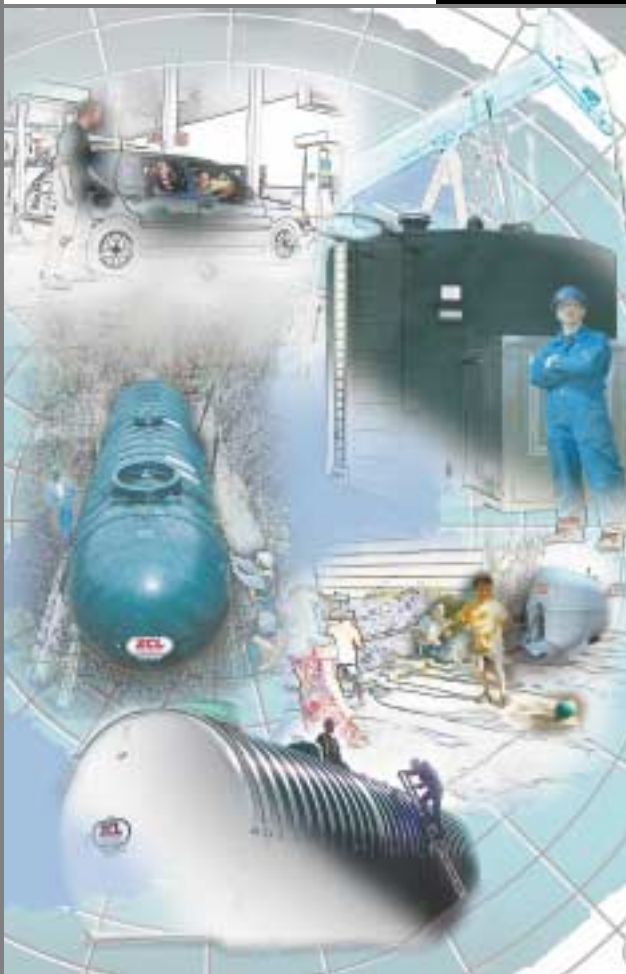


ZCL COMPOSITES INC.
THIRD QUARTER REPORT

2005



Setting a Higher Standard

Message to Shareholders

We are pleased to report record revenue for the third quarter, as well as record results for the nine-month period in terms of both revenue and net income. Revenue for the third quarter increased by 3.1% to \$11.1 million (increased by 9.0% to \$28.4 million for nine months) from \$10.7 million (\$26.0 million for nine months) last year. Net income for the quarter decreased to \$1.0 million (increased to \$2.3 million for nine months) from \$1.1 million (\$1.5 million for nine months) last year. Basic earnings per share for the third quarter of \$0.06 were the same as last year, and increased to \$0.13 for nine months as compared to \$0.08 last year. Diluted earnings per share for the third quarter were \$0.05 (\$0.12 for nine months) as compared to \$0.06 (\$0.08 for nine months) last year.

The outlook for the downstream and upstream sectors of the petroleum industry, along with other traditional markets, continues to be very positive for the remaining part of this fiscal year as well as for next year. The buoyant activity in the second quarter carried through our third quarter, resulting in a strong backlog and start for our fourth quarter. We have had solid acceptance of our products offered to the upstream market, including our recently introduced fiberglass-lined steel tanks manufactured by our ZCL Everlast division. While manufacturing margins have decreased to some extent due to significant raw material increases, we expect to be able to maintain our margins through the efforts and support of our major alliance partners, both suppliers and customers alike.

During the quarter, we signed another major customer long-term contract and are working on others. These relationships are the foundation of our success and an expression of confidence in our commitment and ability to consistently supply high-quality products and services. Our lining products leverage these core competencies and customer relationships and adapt proven technology from our double wall tank manufacturing processes.

Tank lining is a very large and lucrative international market – the potential annual market in North America is estimated to be in excess of \$300 million. We are poised to take advantage of this tremendous opportunity with the anticipated introduction of our Prezerver+Plus+™ lining system early in the next fiscal year. Field trials of this product commenced during the quarter. Preliminary results of this first trial are very encouraging, and further tests will continue to evaluate performance and installation under various site and weather conditions. We will cautiously enter the marketplace

and carefully ramp up the program as we gain field experience and train qualified applicators in all aspects of this new system.

Following the UL approval of our home heating oil tank by Underwriters' Laboratories (UL) for the USA market, we started marketing activities in the New England states during the quarter. Heating or 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 the environmental and liability problems resulting from leaking tanks, and our product offers a new level of security for home owners, insurance companies and lenders. Manufacturing and sales of UL-approved tanks in the USA will begin in the fourth quarter.

As recently announced in the *National Post*, we are very proud to have re-qualified as one of Canada's 50 Best Managed Companies for the second year in a row. This prestigious award reflects the performance and commitment of our entire team. Through innovation and constant improvement, we strive to be the best.

Notwithstanding the slow start in the first quarter, we achieved record revenue in the second and third quarters. Based on our current backlog and the robust level of activity in the upstream sector, we look forward to a strong fourth quarter and are in sight of our annual 15% to 20% growth objective. 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

February 4, 2005

Management's Discussion and Analysis

February 4, 2005

The following discussion and analysis of the results of operations and cash flows for the period ended December 31, 2004, and the financial position as at December 31, 2004, should be read in conjunction with the Company's unaudited consolidated financial statements and related notes for the period ended December 31, 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 Third 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 December 31, 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 third quarter increased by 3.1% to an overall record \$11.1 million (increased by 9.0% to \$28.4 million for nine months) from \$10.7 million (\$26.0 million for nine months) last year. Net income for the quarter decreased to \$1.0 million (increased to \$2.3 million for nine months) from \$1.1 million (\$1.5 million for nine months) in 2003. Basic earnings per share for the third quarter were \$0.06 (\$0.13 for nine months) and diluted earnings per share were \$0.05

(\$0.12 for nine months), as compared to basic and diluted earnings per share of \$0.06 for the quarter (\$0.08 for nine months) last year.

The outlook for the downstream and upstream sectors of the petroleum industry, along with other traditional markets, continues to be very positive for the remaining part of this fiscal year as well as for next year. After a slow start this year, activity and the order backlog picked up during the first quarter, and remained buoyant through the second and third quarters. The fourth quarter, which historically has a lower level of activity, 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.

The slight decrease in net income in the third quarter was due to reduced manufacturing margins, mainly as a result of increased raw material costs, as compared to last year. While overall margins have decreased in the quarter, ongoing margins are expected to be maintained through selling price increases and production improvements. The increase in net income in the nine-month period as compared to last year was due to the higher revenue. Last year, the \$880,000 provision for impairment of the agreement receivable from ZCL Enviro Systems, Inc. ("Enviro") decreased net income for the nine-month period by \$580,000 or \$0.03 per share.

Cash flows from operating activities during the third quarter this year were \$3.6 million (\$2.9 million for nine months), compared to \$4.1 million (\$5.6 million for nine 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 December 31, 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. Last year, long-term debt of \$4.3 million was repaid in the third quarter (\$4.6 million in the nine-month period).

The effect of dilutive share options and warrants was 2,007,432 shares (2003 – nil) for the third quarter and 1,360,581 shares (2003 – nil) for the nine-month period.

Two-thirds of the warrants vested this year, with the first performance threshold of \$1.90 per common share reached in the first quarter, and the second threshold of \$2.85 in the third quarter. 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.

In December 2004, a portion of the Company's manufacturing plant in Waverly, Nova Scotia was destroyed in an electrical fire. This facility is used largely to produce home heating oil tank products. All damaged property, equipment and inventories have been, or will be, repaired or replaced. 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. Manufacturing has resumed and the plant will be fully restored with no major disruptions to production or sales as a result of the fire.

The Company continues to focus on the development and marketing of the tank lining technologies, as well as other new products. In conjunction with customers and suppliers, the Company has developed and is testing new lining materials and processes in order to deliver a superior performing product with inherently safe installation techniques. Field trials commenced in the third quarter and further testing will be conducted to evaluate performance and installation under various site and weather conditions. Product development costs of \$210,000 (2003 – nil) in the third quarter and \$442,000 (2003 – nil) for the nine-month period were deferred.

RESULTS OF OPERATIONS

Period Ended December 31, 2004 Compared to the Period Ended December 31, 2003

Revenue

Revenue in the third quarter increased by 3.1% to \$11.1 million (increased by 9.0% to \$28.4 million for nine months) from \$10.7 million (\$26.0 million for nine 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. Activity picked up in the latter part of the first quarter, and continued through the second and third quarters. 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, 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 \$2.6 million (23.1% of revenue) from \$2.9 million (26.9% of revenue) in the third quarter last year, and remained at the same level of \$6.4 million (22.7% of revenue; 2003 – 24.5% of revenue) for the nine-month period.

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. The decrease in revenue less manufacturing and selling costs in the third quarter was due to reduced margins, mainly as a result of increased raw material costs, as compared to last year. While overall margins have decreased in the quarter, ongoing margins are expected to be maintained through selling price increases and production improvements. 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 \$481,000 (2003 – \$505,000) for the third quarter and to \$1.4 million (2003 – \$1.5 million) for the nine-month period. The overall level of amortization has decreased, and will further moderate 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 third quarter, and will continue in the next quarter. Although the development costs may exceed the initial estimate of \$500,000, the development program is proceeding on schedule and preliminary results of field trials are very encouraging. These development costs will be amortized upon the commercial production of the lining products.

General and administration

General and administration expenses were \$484,000 or 4.4% of revenue (2003 – \$562,000 or 5.2% of revenue) for the third quarter and \$1.4 million or 5.0% of revenue (2003 – \$1.4 million or 5.4% of revenue) for nine 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 nil (2003 – \$110,000) for the third quarter and \$55,000 (2003 – \$150,000) for the nine-month period.

Provision for impairment of agreement receivable

As described in note 6 to the unaudited consolidated financial statements for the period ended December 31, 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 third quarter were \$12,000 (\$55,000 for nine months), down from \$61,000 (\$256,000 for nine months) last year. The decrease is the result of the repayment of long-term bank debt and write-off of related deferred finance costs last year. Short-term interest increased marginally 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 34.9% in the third quarter (34.6% for nine months), as compared to 35.4% (36.7% for nine 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 larger effect last year because of the lower level of pre-tax income.

The Company was in a taxable position in the second and third quarters 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 December 31, 2004 was \$11.4 million, as compared to \$10.1 million at March 31, 2004. Current assets increased by \$2.7 million and current liabilities increased by

\$1.4 million. At December 31, 2004, accounts receivable increased by \$939,000 from March 31, 2004 to \$7.3 million, inventories increased by \$1.8 million to \$7.3 million, accounts payable and accrued liabilities increased by \$516,000 to \$5.0 million, and income taxes payable increased by \$914,000 to \$949,000. These increases reflect the elevated level of operations during the period. Inventories have been maintained at higher levels to meet the higher activity anticipated in the fourth 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 December 31, 2004, the two largest customers accounted for approximately 24% (March 31, 2004 – two customers, 26%) of accounts receivable.

As a result of the increase in cash during the period, net repayment of the revolving operating lines of credit (bank indebtedness) was \$1.3 million (2003 – nil) during the third quarter with a remaining cash balance of \$2.1 million at December 31, 2004. The Company has operating lines of credit of \$10.3 million provided by a chartered bank that are not utilized.

Cash flows from operating activities during the third quarter this year were \$3.6 million (\$2.9 million for nine months), compared to \$4.1 million (\$5.6 million for nine 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 December 31, 2004) and the build-up of inventories this year.

Share options and warrants were exercised for cash of \$76,000 in the third quarter (2003 – nil) and \$302,000 for the nine-month period (2003 – nil). During the second quarter this year, dividends of \$1.1 million (2003 – nil) were paid. Last year, long-term debt of \$4.3 million was repaid in the third quarter (\$4.6 million in the nine-month period). 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 \$210,000 (2003 – nil) in the third quarter and \$442,000 (2003 – nil) for the nine-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 third quarter last year, 221,000 common shares (222,000 for the nine-month period) were repurchased for cancellation 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 December 31, 2004. There are no ongoing contractual or other commitments resulting from these transactions.

OUTLOOK

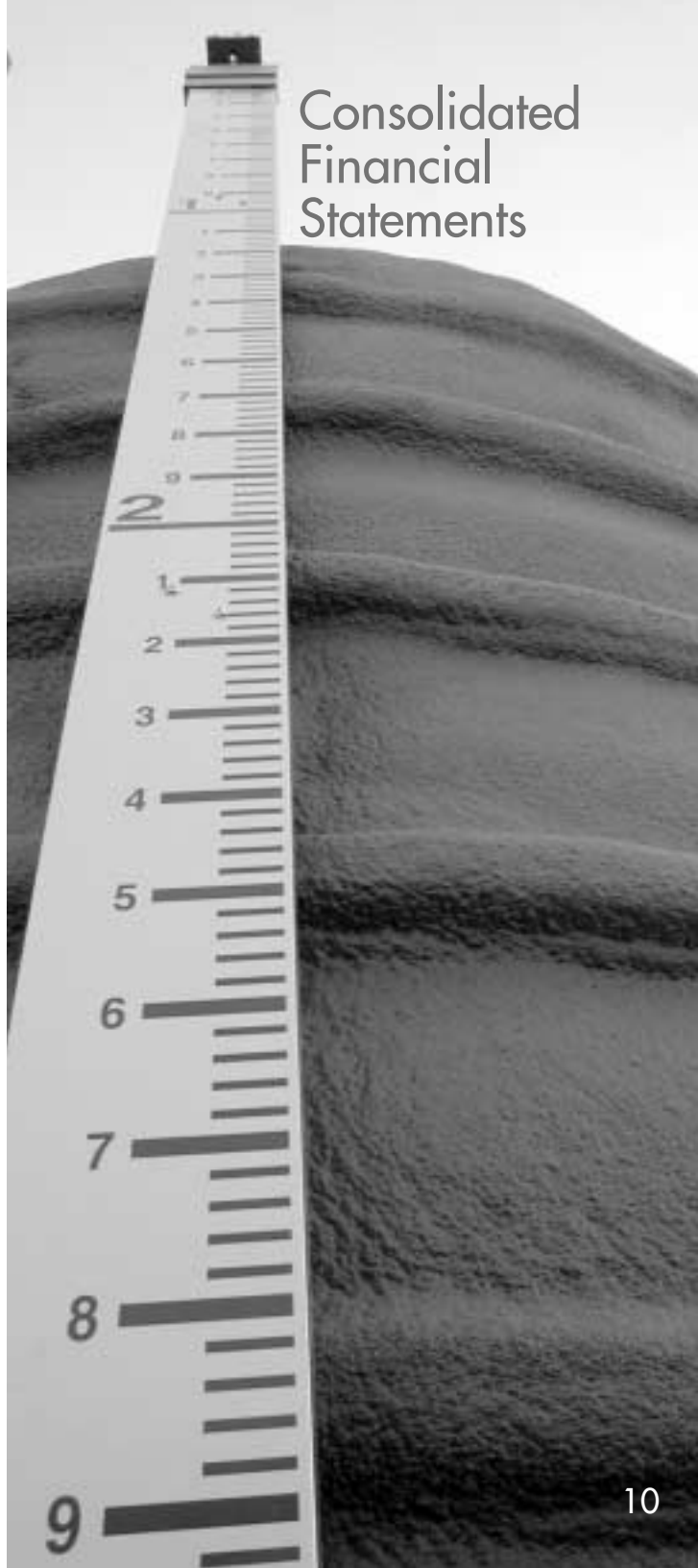
The Company's outlook remains as described in the Management's Discussion and Analysis included in the March 31, 2004 Annual Report.

OTHER

Outstanding Share Data

As at February 4, 2005, there were 17,828,919 common shares, 1,190,734 share options and 3,530,878 warrants outstanding.

Consolidated Financial Statements



Consolidated Balance Sheets

(Unaudited)

(in thousands of dollars)	December 31 2004 \$	March 31 2004 \$
Assets		
Current		
Cash	2,129	1,880
Accounts receivable	7,302	6,363
Inventories	7,326	5,556
Prepaid expenses	291	188
Future tax assets	324	699
	17,372	14,686
Property, plant and equipment	8,300	7,814
Deferred costs (note 3)	645	717
Intangible assets	1,196	1,324
Goodwill	1,991	1,926
	29,504	26,467
Liabilities and Shareholders' Equity		
Current		
Accounts payable and accrued liabilities	5,041	4,525
Income taxes payable	949	35
Future tax liabilities	27	27
	6,017	4,587
Government grants	154	160
Future tax liabilities	793	838
	6,964	5,585
Shareholders' equity		
Share capital (note 5a)	19,168	18,853
Contributed surplus (note 5a and 5b)	142	77
Retained earnings	3,230	1,952
	22,540	20,882
	29,504	26,467

See accompanying notes

Consolidated Statements of Income and Retained Earnings (Deficit)

(Unaudited)

Periods ended December 31

	Three months		Nine months	
	2004	2003	2004	2003
(in thousands of dollars, except per share amounts)	\$	\$	\$	\$
Revenue	11,056	10,726	28,384	26,031
Manufacturing and selling costs	8,500	7,843	21,935	19,666
	2,556	2,883	6,449	6,365
Amortization (note 3)	481	505	1,426	1,504
General and administration	484	562	1,407	1,406
Provision for impairment of agreement receivable (note 6)	—	—	—	880
Financing charges	12	61	55	256
Income before income taxes	1,579	1,755	3,561	2,319
Income taxes				
Current	551	6	902	17
Future	—	615	330	835
	551	621	1,232	852
Net income for the period	1,028	1,134	2,329	1,467
Retained earnings (deficit), beginning of the period	2,202	333	1,952	(9,043)
Deficit elimination (note 5a)	—	—	—	9,043
Dividends (note 7)	—	—	(1,051)	—
Retained earnings, end of the period	3,230	1,467	3,230	1,467
Basic earnings per share (note 8)	\$0.06	\$0.06	\$0.13	\$0.08
Diluted earnings per share (note 8)	\$0.05	\$0.06	\$0.12	\$0.08

See accompanying notes

Consolidated Statements of Cash Flows

(Unaudited)

Periods ended December 31

	Three months		Nine months	
	2004	2003	2004	2003
(in thousands of dollars)	\$	\$	\$	\$
Cash Flows from Operating Activities				
Cash receipts from customers	12,458	11,645	27,375	27,004
Cash paid to suppliers and employees	(8,824)	(7,521)	(24,423)	(21,137)
Interest paid	(19)	(43)	(55)	(192)
Income taxes recovered (paid)	24	(24)	12	(45)
	3,639	4,057	2,909	5,630
Cash Flows from Financing Activities				
Net repayment of bank indebtedness (note 4)	(1,328)	—	—	—
Issue of common shares (note 5a)	76	—	302	—
Dividends (note 7)	—	—	(1,051)	—
Repayment of long-term debt	—	(4,285)	—	(4,643)
Repurchase of common shares for cancellation (note 5a)	—	(188)	—	(189)
	(1,252)	(4,473)	(749)	(4,832)
Cash Flows from Investing Activities				
Business acquisition (note 2)	—	—	(1,193)	—
Purchase of property, plant and equipment	(48)	(151)	(276)	(422)
Deferred development costs (note 3)	(210)	—	(442)	—
	(258)	(151)	(1,911)	(422)
Increase (decrease) in cash	2,129	(567)	249	376
Cash, beginning of the period	—	2,276	1,880	1,333
Cash, end of the period	2,129	1,709	2,129	1,709

See accompanying notes

Notes to Consolidated Financial Statements

December 31, 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 December 31, 2004 was comprised of deferred development costs of \$645,000 (March 31, 2004 - \$717,000). Product development costs of \$210,000 for the third quarter (2003 - nil) and \$442,000 for the nine-month period (2003 - nil) were incurred. These costs incurred related to development projects in process at December 31, 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 December 31 (in thousands of dollars)	Three months 2004 2003		Nine months 2004 2003	
	\$	\$	\$	\$
Property, plant and equipment	202	187	590	553
Deferred development costs	171	179	514	534
Deferred startup costs	—	35	—	105
Intangible assets	110	106	328	318
Government grants	(2)	(2)	(6)	(6)
	481	505	1,426	1,504

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% (4.50%; 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 (i)	—	—	—	(8,298)
Share options exercised for cash	102,600	98	—	—
Warrants exercised for cash	135,000	128	—	—
Repurchased under normal course issuer bid (ii)	—	—	(1,000)	(2)
Balance, as at September 30	17,748,920	19,079	17,715,920	19,078
Share options exercised for cash	61,666	59	—	—
Warrants exercised for cash (iii)	18,333	30	—	—
Repurchased under normal course issuer bid (ii)	—	—	(221,000)	(238)
Balance, as at December 31	17,828,919	19,168	17,494,920	18,840

(i) 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.

(ii) In the third quarter of 2003, 221,000 common shares (222,000 for the nine-month period) were repurchased for cancellation pursuant to a normal course issuer bid at a cost of \$188,000 (\$189,000 for the nine-month period). As a result, share capital was reduced by \$238,000 (\$240,000 for the nine-month period) and contributed surplus was increased by \$50,000 (\$51,000 for the nine-month period).

(iii) The credit to share capital related to the warrants exercised during the third quarter this year includes \$13,000 in respect of compensation expense previously included in contributed surplus.

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 this year, the Company granted 260,000 share options with exercise prices at the market share price on the grant date (2003 – granted 50,000 options during the second quarter with exercise prices in excess of the market price on the grant date), and transferred to employees 230,000 warrants with exercise prices below the market share price on the transfer date (2003 – transferred 150,000 warrants during the first quarter with exercise prices in excess of the market price on the transfer date). \$33,000 (2003 – \$3,000) in the third quarter, and \$69,000 (2003 – \$7,000) in the nine-month period, were recorded as contributed surplus and stock-based compensation 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, \$1,000 (2003 – \$12,000) in the third quarter and \$9,000 (2003 – \$12,000) in the nine-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

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

b) Stock-based compensation – continued

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 December 31 <small>(in thousands of dollars, except earnings per share)</small>	Three months		Nine months	
	2004	2003	2004	2003
Net income for the period	1,028	1,134	2,329	1,467
Compensation expense	51	53	154	162
Pro-forma net income for the period	977	1,081	2,175	1,305

Earnings per share:

Reported basic earnings per share	0.06	0.06	0.13	0.08
Compensation expense per share	0.00	0.00	0.01	0.01
Pro-forma basic earnings per share	0.06	0.06	0.12	0.07
Reported diluted earnings per share	0.05	0.06	0.12	0.08
Compensation expense per share	0.00	0.00	0.01	0.01
Pro-forma diluted earnings per share	0.05	0.06	0.11	0.07

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 December 31	Three months		Nine months	
	2004	2003	2004	2003
Weighted-average shares for basic earnings per share	17,797,615	17,629,442	17,626,107	17,687,375
Weighted-average shares for diluted earnings per share	19,805,047	17,629,442	18,986,688	17,687,375

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 \$165,000 (2003 – \$101,000) for the third quarter, and \$340,000 (2003 – \$333,000) for the nine-month period, were provided by a corporation controlled by a director of the Company. Accounts payable and accrued liabilities at December 31, 2004 included \$8,000 (March 31, 2004 – \$6,000) owing to the corporation. Normal commercial rates were paid for these services.

10. Derivative Financial Instruments

At December 31, 2004, the Company no longer had any foreign currency collar arrangements not accounted for as hedges. These arrangements had provided for the purchase of euros at set rates. During the three-month and nine-month periods, net realized and unrealized losses of less than \$3,000 (2003 – \$5,000) related to derivative financial instruments were recorded in financing charges.

ZCL COMPOSITES INC.

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

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**

Corporate Office

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