

# Environment <sup>Focus</sup> Innovation

ZCL Composites Inc  
Third Quarter Report 2006



**ZCL**  
COMPOSITES INC.

# Message To Shareholders

ZCL is pleased to report our third consecutive record for quarterly revenue for the period ended December 31, 2005. This was achieved on the strength of increased activities in the Oil and Gas sector and in large part due to the increased activities at all of our Western facilities. The outlook 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, ethanol and other blends of fuels being legislated in various parts of Canada and USA.

Accordingly, revenue for the third quarter increased by 18.0% to a record \$13,044,000 up from \$11,056,000 for the corresponding quarter last year, and increased by 14.5% to \$32,505,000 for the nine month period from \$28,384,000 for the nine month period last year. With our expanding order backlog and a strong start to the fourth quarter, we remain confident that we can achieve our growth objective of 15% to 20% in terms of revenue with increasing margins in future quarters as a result of our announced price increases which will have a greater impact in the fourth quarter this year.

Net income for the third quarter increased to \$1,065,000 from \$1,028,000 last year, and was \$2,129,000 for the nine month period, slightly lower than the \$2,329,000 of last year. Basic earnings per share for the third quarter were \$0.06 as compared to \$0.06 last year, and \$0.12 for the nine month period as compared to \$0.13 last year. Diluted earnings per share for the third quarter were \$0.05 as compared to \$0.05 last year, and \$0.11 for the nine month period as compared to \$0.12 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 along with increased expenses for marketing and sales activities related to home heating oil and tank lining products. Selling price increases have begun to take effect, translating into increased margins which are expected to further improve in the coming months and into the next fiscal year.

Our lining program proceeded as planned and we have now concluded the evaluation and testing with respect to obtaining Underwriters' Laboratories of Canada ("ULC") and Underwriters' Laboratories ("UL") listings in accordance with recognized industry standards. We are now awaiting formal approval from ULC and UL. Our lining system marketing program was successfully 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 early part of our 2007 fiscal year.

With respect to our home heating oil product line, we entered into a marketing campaign with ING Insurance, providers of home insurance, and Sears Canada's "HVAC" (Heating Ventilation & Air Conditioning) division, whereby we offer very attractive incentives for the purchase of the product. Since then, we have sold and delivered truck load quantities of tanks during the third quarter. While not significant in terms of revenue (under \$1,000,000) this is a positive beginning. We have also begun selling tanks in similar quantities to our other Alliance partners such as Irving Oil,

for delivery within Atlantic Canada as well as on the US side of the border. There are approximately 8 million households in North America using home heating oil. Our plan is to systematically achieve a significant share of this market over the next five years, and we are off to a good start.

We purchased all of the application patents as well as the exclusive rights for manufacturing the three dimensional fabric marketed as "Parabeam". The purchase of these patents provides the Company with control over the Parabeam product. This action further solidifies our growth strategies in the North American and Global marketplaces.

As mentioned above, while this product can be used in the manufacturing of double wall tanks, as well as other types of products, it can also be used in the lining of both underground and above ground tanks. As stated earlier, the product submitted for ULC and UL approval includes this material and is an integral part of our lining system. Our lining system provides a built in secondary system which can be applied in situ and is marketed under the trade names Lifeliner™ and Phoenix® systems.

In the current environment where many companies acknowledge the challenge of recruiting and retaining high quality people, we are pleased to announce that for the third consecutive year, we have re-qualified and are one of the winners of the nationally acclaimed competition known as "Canada's 50 Best Managed Companies" which recognizes innovative thinking, product and service excellence and commitment to people. The 50 Best Managed program is a national competition that recognizes Canadian companies that employ best business practices. The program was created in 1993 and recognizes companies operating at the highest levels of business performance. The 50 Best Managed designation symbolizes Canadian corporate success: companies focused on their core vision, creating stakeholder value and excelling in the global economy.

During the third quarter, a major shareholder who previously held approximately 43% of our outstanding shares, decided to sell substantially all of its ownership position in the company. These shares were purchased by a wide number of private and institutional investors thereby affording an improvement in liquidity. We appreciate the support given to us by this shareholder during that period when we were developing and introducing new products and expanding through acquisitions. Currently only three shareholders hold more than 10% each of the outstanding shares with no one owning more than 13%.

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

February 2, 2006

# Management's Discussion and Analysis

February 2, 2006

*The following discussion and analysis of the results of operations and cash flows for the period ended December 31, 2005, and the financial position as at December 31, 2005, should be read in conjunction with the Company's unaudited consolidated financial statements and related notes for the period ended December 31, 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 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, 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 December 31, 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.

Revenue for the third quarter increased by 18.0% to a record \$13,044,000 up from \$11,056,000 for the corresponding quarter last year, and increased by 14.5% to \$32,505,000 for the nine month period from \$28,384,000 for the nine month period last year. With our expanding order backlog and the strong start to the fourth quarter, we remain confident that we can achieve our growth objective of 15% to 20% in terms of revenue with increasing margins in future quarters as a result of our announced price increases which will have a greater impact into the fourth quarter this year.

Net income for the third quarter increased to \$1,065,000 from \$1,028,000 last year, and to \$2,129,000 for the nine month period which was slightly lower than the \$2,329,000 of last year. Basic earnings per share for the third quarter were \$0.06 as compared to \$0.06 last year, and \$0.12 for the nine month period as compared to \$0.13 last year. Diluted earnings per share for the third quarter were \$0.05 as compared to \$0.05 last year, and \$0.11 for the nine month period as compared to \$0.12 last year.

The overall increase in revenue was primarily due to the acquisition of Triple M Fiberglass Mfg. Ltd. ("Triple M") in April 2005 and the increased demand for our products sold to the upstream sector of the Oil & Gas industry. The outlook for this market sector, as well as other traditional markets of the Company, remains very positive for the remainder of this fiscal year. The order backlog is very strong and the fourth quarter is off to a good start.

Notwithstanding the higher revenue during the period, the decrease in the year to date net income was largely due to lower overall margins, as a result of increased raw material prices. We also incurred increased expenses for marketing and sales activities related to home heating oil and tank lining products. Financing costs were higher this year primarily due to the acquisition of Triple M and the purchase of patents. Amortization decreased this year as certain deferred costs were fully amortized in the third quarter last year.

Cash flows from operating activities were \$588,000 during the third quarter (\$1,381,000 for the nine month period) this year, after the payment of income taxes of \$315,000 in the quarter (\$1,892,000 in the nine month period), compared to \$3,639,000 of cash generated in operating activities during the quarter (\$2,909,000 for the nine month period) last year. This quarter over quarter decrease was largely due to the timing of sales and collection of accounts receivable, the timing of the payment of accounts payable and the level of operations. In terms of financing and investing activity, the payment of the Triple M acquisition during the first quarter and the purchase of patent and manufacturing rights in the third quarter were an additional use of funds.

## *Management's Discussion and Analysis continued*

The second annual dividend of \$0.08 (2004 – \$0.06) per common share was declared in the first quarter this year and dividends of \$1,438,000 (2004 - \$1,051,000) were paid in the second quarter. The shares of Triple M, including bank indebtedness assumed, were acquired for cash of \$2,597,000 in the first quarter this year, and the business assets of Durex Steel & Alloy Industries Ltd. ("Durex") were purchased for cash of \$1,193,000 in the first quarter last year.

The effect of dilutive share options and warrants on the weighted-average shares outstanding was 2,225,311 shares (2004 – 2,007,432) for the third quarter and 2,244,558 (2004 – 1,360,581) for the nine month period. Two-thirds of the outstanding warrants vested last fiscal year. The remaining warrants were not included in the calculation of diluted shares in 2005 and 2004 as the market price was below the performance threshold.

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 December 31, 2005 included \$303,000 (March 31, 2005 - \$590,000) related to the insurance claim. The Company's underwriters have recently assured us that all claims should be settled in the near future.

With respect to our home heating oil product line, the Company entered into a marketing campaign with ING Insurance, providers of home insurance, and Sears Canada's "HVAC" (Heating Ventilation & Air Conditioning) division, whereby we offer very attractive incentives for the purchase of the product. Since then, we have sold and delivered truck load quantities of tanks during the third quarter. While not significant in terms of revenue (under \$1,000,000) this is a beginning as we have also begun selling tanks in similar quantities to our other Alliance partners such as Irving Oil for delivery within Atlantic Canada and on the US side of the border. There are approximately 8 million households in North America using home heating oil. Our plan is to systematically achieve a significant share of this market over the next five years, and we are off to a good start.

The Company purchased all of the application patents as well as the exclusive rights for manufacturing the three dimensional fabric marketed as "Parabeam". The purchase of these patents provides the Company with control over the Parabeam product. This action further solidifies the Company's growth strategies in the North American and Global marketplace.

Tank lining development costs of \$104,000 (2004 - \$210,000) during the third quarter and \$677,000 (2004 – \$442,000) in the nine month period were deferred. Actual expenditures in the third quarter were \$263,000 but were offset by \$159,000 for investment tax credits received under the federal government Scientific Research and Experimental Development program. The final testing of the Company's tank lining technologies was successfully completed in the third quarter. While the overall level of development costs has exceeded the initial estimated amount, the development program progressed as planned and the second quarter field test of the lining product was completed in the third quarter. Evaluation and testing with respect to obtaining Underwriters' Laboratories of Canada ("ULC") and Underwriters' Laboratories ("UL") listings in accordance with recognized industry standards was successfully completed in the third quarter and we are awaiting formal approval. Lining systems will be introduced to the marketplace in a deliberate and measured manner 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. This new product is expected to add to revenue in the early part of fiscal 2007.

## RESULTS OF OPERATIONS

*Period Ended December 31, 2005 Compared to the Period Ended December 31, 2004*

### **Revenue**

Revenue for the third quarter increased by 18.0% to a record \$13,044,000 up from \$11,056,000 for the corresponding quarter last year, and increased by 14.5% to \$32,505,000 for the nine month period from \$28,384,000 for the nine month period last year.

Net income for the third quarter increased to \$1,065,000 from \$1,028,000 last year was \$2,129,000 for the nine month period, slightly lower than the \$2,329,000 of last year. Basic earnings per share for the third quarter were \$0.06 as compared to \$0.06 last year, and \$0.12 for the nine month period as compared to \$0.13 last year. Diluted earnings per share for the third quarter were \$0.05 as compared to \$0.05 last year, and \$0.11 for the nine month period as compared to \$0.12 last year.

The overall increase in revenue was primarily due to the acquisition of Triple M Fiberglass Mfg. Ltd. ("Triple M") in April 2005, and the increased demand for products sold to the upstream markets in the Oil and Gas industry. The outlook for this market sector, as well as other traditional markets of the Company, remains very positive for the remainder of this fiscal year. The order backlog is very strong and the fourth quarter is off to a good start.

## *Management's Discussion and Analysis continued*

Products introduced in recent years – home heating oil tanks, Protektor<sup>®</sup> and Pinnacle<sup>™</sup> oilfield tanks, filament wound pressure vessels, as well as custom storage and lining systems – continue to gain market acceptance and add to revenue.

### **Revenue less manufacturing and selling costs**

Revenue less manufacturing and selling costs increased to \$2,742,000 (21.0% of revenue) from \$2,556,000 million (23.1% of revenue) in the third quarter last year, and decreased to \$6,274,000 (19.3% of revenue) from \$6,449,000 (22.7% of revenue) for the nine month period last year. Manufacturing and selling costs include direct materials and labour, variable and fixed manufacturing overhead, marketing and selling expenses, and exclude amortization, general and administration, and financing charges.

Notwithstanding the higher revenue during the period, the net income in the third quarter was flat and the decrease in the nine month period this year was largely due to lower overall margins, as a result of increased raw material prices 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 introduced during the third quarter.

### **Amortization**

Amortization decreased by \$102,000 to \$379,000 for the third quarter from \$481,000 last year, and decreased by \$315,000 to \$1,111,000 for the nine month period from \$1,426,000 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 three 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 \$655,000 or 5.0% of revenue (2004 - \$484,000 or 4.4% of revenue) for the third quarter, and \$1,608,000 or 4.9% of revenue (2004- \$1,407,000 or 5.0% of revenue) for the nine month period. These costs are increasing as the Company grows and are reflected in higher salaries. We also incurred higher professional fees related to the tax work undertaken for the investment tax credits received under the federal government Scientific Research and Experimental Development program. General and administrative costs will increase as the Company expands, however, our expectation is that these costs will not increase proportionately with sales.

### **Financing charges**

Financing charges for the third quarter were \$56,000 (\$219,000 for the nine month period), up from \$12,000 for the quarter (\$55,000 for the nine 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 35.5% in the third quarter (36.2% for the nine month period), as compared to 34.9% for the quarter (34.6% for the nine 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 three quarters this year. Tax losses of prior years have been utilized. Long term future tax liabilities of \$1,589,000 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)

	Dec 31/05	Sep 30/05	Jun 30/05	Mar 31/05
Revenue	13,044	11,173	8,287	10,372
Net income	1,065	820	244	1,151
Basic earnings per share	\$0.06	\$0.05	\$0.01	\$0.07
Diluted earnings per share	\$0.05	\$0.04	\$0.01	\$0.06

  

	Dec 31/04	Sep 30/04	Jun 30/04	Mar 31/04
Revenue	11,056	11,020	6,308	7,901
Net income	1,028	1,229	72	485
Basic earnings per share	\$0.06	\$0.07	\$0.00	\$0.03
Diluted earnings per share	\$0.05	\$0.07	\$0.00	\$0.03

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 December 31, 2005 was \$12,145,000, as compared to \$12,898,000 at March 31, 2005. Current assets increased by \$105,000 and current liabilities increased by \$858,000. These changes reflect the operations, income taxes paid, dividends paid and cash acquisition of Triple M during the period.

At December 31, 2005, accounts receivable increased by \$98,000 from March 31, 2005 to \$11,392,000, inventories increased by \$1,631,000 to \$8,751,000, accounts payable and accrued liabilities decreased by \$1,093,000 to \$5,244,000, and income tax payable decreased by \$1,075,000 from \$1,336,000 to \$261,000. Bank indebtedness was \$2,776,000 at the end of the third quarter compared to a positive cash balance of \$1,383,000 at March 31, 2005.

These changes reflect the continued strong level of operations, acquisition of Triple M, the purchase of patents and the payment of income taxes during the period. Inventories have been maintained at higher levels to meet the robust activity anticipated in the fourth quarter of this fiscal year.

No single 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, 2005, the Company's four largest customers accounted for approximately 22% (March 31, 2005 – two customers, 22%) of accounts receivable.

## Cash Flows

Summary of Cash Flows Periods ended December 31 (in thousands of dollars)	Three months		Nine months	
	2005	2004	2005	2004
	\$	\$	\$	\$
Operating activities	588	3,639	1,381	2,909
Financing activities	7	(1,252)	1,467	(749)
Investing activities	(595)	(258)	(4,231)	(1,911)
Decrease in cash	—	2,129	(1,383)	249
Cash, beginning of the period	—	—	1,383	1,880
Cash, end of the period	—	2,129	—	2,129

Cash flows from operating activities were \$588,000 during the third quarter (\$1,381,000 for the nine month period) this year, after the payment of income taxes of \$315,000 in the quarter (\$1,892,000 in the nine month period), compared to \$3,639,000 of cash supplied from operating activities during the quarter (\$2,909,000 for the nine month period) last year. This decrease was largely due to the timing of sales and collection of accounts receivable and the higher level of operations. In terms of financing and investing activities, the purchase of patents and the acquisition of Triple M during the period were a further use of funds.

As a result of the decrease in cash during the period, net advances on the revolving operating lines of credit (bank indebtedness) were \$67,000 (2004 – \$1,328,000 reduction) during the third quarter and \$2,776,000 (2004 - nil) during the nine month period. The Company has operating lines of credit of \$10,250,000 provided by a chartered bank.

The shares of Triple M were acquired for cash of \$2,597,000, including bank indebtedness assumed, in the first quarter this year, and the business assets of Durex were purchased for cash of \$1,193,000 in the first quarter last year. Product development costs, related to lining

## *Management's Discussion and Analysis continued*

materials and processes, of \$104,000 (2004 – \$210,000) in the third quarter, and \$677,000 (2004 – \$442,000) in the nine month period, were deferred. Property, plant and equipment additions were \$122,000 (2004 – \$48,000) in the third quarter and \$588,000 (2004 – \$276,000) in the nine 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. During the quarter, ZCL purchased rights and patents for the Parabeam product for \$369,000.

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 leases included 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 December 31, 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 February 2nd, 2006, there were 19,398,621 common shares, 1,152,401 share options and 2,089,509 warrants outstanding.

# Consolidated Balance Sheets

(unaudited)

	December 31	March 31
	2005	2005
	\$	\$
<i>(in thousands of dollars)</i>		
<b>Assets</b>		
<b>Current</b>		
Cash	–	1,383
Accounts receivable	11,392	11,294
Inventories	8,751	7,120
Prepaid expenses	373	548
Future tax assets	184	250
	<b>20,700</b>	<b>20,595</b>
Property, plant and equipment	9,834	8,246
Deferred costs <i>[note 3]</i>	1,370	707
Intangible assets <i>[note 3]</i>	1,181	1,085
Goodwill	1,991	1,991
	<b>35,076</b>	<b>32,624</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current</b>		
Bank indebtedness <i>[note 4]</i>	2,776	–
Accounts payable and accrued liabilities	5,244	6,337
Income taxes payable	261	1,336
Future tax liabilities	274	24
	<b>8,555</b>	<b>7,697</b>
Government grants	145	151
Future tax liabilities	1,589	947
	<b>10,289</b>	<b>8,795</b>
<b>Shareholders' equity</b>		
Share capital <i>[note 5a]</i>	19,405	19,277
Contributed surplus <i>[note 5a]</i>	310	171
Retained earnings	5,072	4,381
	<b>24,787</b>	<b>23,829</b>
	<b>35,076</b>	<b>32,624</b>

See accompanying notes

# Consolidated Statements of Income and Retained Earnings

(unaudited)

Periods ended December 31	Three months		Nine months	
	2005	2004	2005	2004
(in thousands of dollars, except per share amounts)	\$	\$	\$	\$
<b>Revenue</b>	<b>13,044</b>	<b>11,056</b>	<b>32,505</b>	<b>28,384</b>
Manufacturing and selling costs <i>[notes 6a and 7]</i>	10,302	8,500	26,231	21,935
	2,742	2,556	6,274	6,449
Amortization <i>[note 3]</i>	379	481	1,111	1,426
General and administration <i>[note 6a]</i>	655	484	1,608	1,407
Financing charges <i>[note 8]</i>	56	12	219	55
<b>Income before income taxes</b>	<b>1,652</b>	<b>1,579</b>	<b>3,336</b>	<b>3,561</b>
<b>Income taxes</b>				
Current	602	551	817	902
Future	(15)	–	390	330
	587	551	1,207	1,232
<b>Net Income for the period</b>	<b>1,065</b>	<b>1,028</b>	<b>2,129</b>	<b>2,329</b>
Retained earnings, beginning of the period	4,007	2,202	4,381	1,952
Dividends <i>[note 5b]</i>	–	–	(1,438)	(1,051)
<b>Retained earnings, end of the period</b>	<b>5,072</b>	<b>3,230</b>	<b>5,072</b>	<b>3,230</b>
<b>Basic earnings per share</b> <i>[note 9]</i>	<b>\$0.06</b>	<b>\$0.06</b>	<b>\$0.12</b>	<b>\$0.13</b>
<b>Diluted earnings per share</b> <i>[note 9]</i>	<b>\$0.05</b>	<b>\$0.05</b>	<b>\$0.11</b>	<b>\$0.12</b>

See accompanying notes

# Consolidated Statements of Cash Flows

(unaudited)

Periods ended December 31

	Three months		Nine months	
	2005	2004	2005	2004
(in thousands of dollars)	\$	\$	\$	\$
<b>Cash Flows from Operating Activities</b>				
Cash receipts from customers	11,341	12,458	33,567	27,375
Cash paid to suppliers and employees	(10,377)	(8,824)	(30,084)	(24,423)
Interest paid	(61)	(19)	(210)	(55)
Income taxes paid	(315)	24	(1,892)	12
	<b>588</b>	<b>3,639</b>	<b>1,381</b>	<b>2,909</b>
<b>Cash Flows from Financing Activities</b>				
Net advances on bank indebtedness <i>[note 4]</i>	(67)	(1,328)	2,777	–
Issue of common shares <i>[note 5a]</i>	74	76	128	302
Dividends <i>[note 5b]</i>	–	–	(1,438)	(1,051)
	<b>7</b>	<b>(1,252)</b>	<b>1,467</b>	<b>(749)</b>
<b>Cash Flows from Investing Activities</b>				
Business acquisition, including bank indebtedness assumed <i>[note 2]</i>	–	–	(2,597)	(1,193)
Purchase of property, plant and equipment	(122)	(48)	(588)	(276)
Intangible assets <i>[note 3]</i>	(369)	–	(369)	–
Deferred development costs <i>[note 3]</i>	(104)	(210)	(677)	(442)
	<b>(595)</b>	<b>(258)</b>	<b>(4,231)</b>	<b>(1,911)</b>
<b>Increase (decrease) in cash</b>	<b>–</b>	<b>2,129</b>	<b>(1,383)</b>	<b>249</b>
Cash, beginning of the period	–	–	1,383	1,880
<b>Cash, end of the period</b>	<b>–</b>	<b>2,129</b>	<b>–</b>	<b>2,129</b>

See accompanying notes

# Notes to Consolidated Financial Statements

December 31, 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 highest 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)
<b>Net assets acquired</b>	<b>2,000</b>

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
<b>Total assets acquired</b>	<b>1,193</b>

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, 2005 and March 31, 2005 is comprised of deferred development costs and includes \$104,000 (2004 - \$210,000) of development costs incurred during the third quarter and \$677,000 (2004 - \$442,000) incurred during the nine month period. These costs incurred related to development projects in process at December 31, 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.

During the third quarter, the company acquired certain patents and other exclusive rights relating to the Parabeam product and production processes. The cost capitalized for these assets of \$369,000 will be amortized over the remaining life of the patents commencing in the fourth quarter.

Amortization expense consists of amortization of the following:

Periods ended December 31  (in thousands of dollars)	Three months		Nine months	
	2005	2004	2005	2004
	\$	\$	\$	\$
Property, plant and equipment	247	202	716	590
Deferred development costs	4	171	13	514
Intangible assets	130	110	388	328
Government grants	(2)	(2)	(6)	(6)
	<b>379</b>	<b>481</b>	<b>1,111</b>	<b>1,426</b>

### 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% (5.00%; 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

(in thousands of dollars, except shares)	Share Capital		Contributed Surplus			
	2005	2004	2005	2004		
	Shares #	\$	Shares #	\$		
<b>Balance, as at March 31</b>	<b>17,943,919</b>	<b>19,277</b>	<b>17,511,320</b>	<b>18,853</b>	<b>171</b>	<b>77</b>
Share options exercised for cash	33,333	40	102,600	98	–	–
Warrants exercised for cash	14,966	14	135,000	128	–	–
Stock-based compensation	–	–	–	–	86	44
<b>Balance, as at September 30</b>	<b>17,992,218</b>	<b>19,331</b>	<b>17,748,920</b>	<b>19,079</b>	<b>257</b>	<b>121</b>
Share options exercised for cash	75,000	71	61,666	59	–	–
Warrants exercised for cash	3,333	3	18,333	30	–	(13)
Stock-based compensation	–	–	–	–	53	34
<b>Balance, as at December 31</b>	<b>18,070,551</b>	<b>19,405</b>	<b>17,828,919</b>	<b>19,168</b>	<b>310</b>	<b>142</b>

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.

The credit to share capital related to the warrants exercised during the third quarter of 2004 included \$13,000 in respect of compensation expense previously included in contributed surplus.

#### 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
	#	#	#	#
<b>Balance, as at March 31</b>	<b>1,160,734</b>	<b>3,445,878</b>	1,145,000	3,684,211
Granted	–	–	260,000	–
Exercised	(33,333)	(14,966)	(102,600)	(135,000)
<b>Balance, as at September 30</b>	<b>1,127,401</b>	<b>3,430,912</b>	1,302,400	3,549,211
Granted	100,000	–	–	–
Exercised	(75,000)	(3,333)	(36,666)	(18,333)
Forfeited	–	(10,000)	–	–
<b>Balance, as at December 31</b>	<b>1,152,401</b>	<b>3,417,579</b>	1,265,734	3,530,878

Subsequent to December 31, 2005, 1,328,070 of the above warrants were exercised for \$0.95 per warrant resulting in the issue of 1,328,070 common shares and the receipt of \$1,261,667 in cash.

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 third quarter this year, 100,000 share options were granted with exercise prices at the market share price on the grant date (2004 – no share options were granted), and no (2004 – nil) warrants were transferred to employees. Stock based compensation expense of \$53,000 (2004 - \$33,000) in the third quarter and \$139,000 (2004 - \$69,000) in the nine 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 at Market	Granted in Excess of Market	Transferred in Excess of Market	Transferred Below Market
Weighted-average fair value	\$0.74	\$0.29	\$0.18	\$1.02
Risk-free interest rate (%)	3.83	3.89	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 (%)	53.5	60.8	60.5	53.1
Dividend yield (%)	0.69	0.00	0.00	0.92

In accordance with the fair value method of accounting for stock based compensation for non employees, nil (2004 - \$1,000) in the third quarter and nil (2004 - \$9,000) in the nine 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 December 31	Three months		Nine months	
	2005	2004	2005	2004
(in thousands of dollars, except earnings per share)	\$	\$	\$	\$
Net income for the period	1,065	1,028	2,129	2,329
Compensation expense	51	51	155	154
<b>Pro-forma net income for the period</b>	<b>1,014</b>	<b>977</b>	<b>1,974</b>	<b>2,175</b>
<b>Earnings per share:</b>				
Reported basic earnings per share	0.06	0.06	0.06	0.13
Compensation expense per share	0.00	0.00	0.01	0.01
<b>Pro-forma basic earnings per share</b>	<b>0.06</b>	<b>0.06</b>	<b>0.05</b>	<b>0.12</b>
Reported diluted earnings per share	0.05	0.05	0.05	0.12
Compensation expense per share	0.00	0.00	0.01	0.01
<b>Pro-forma diluted earnings per share</b>	<b>0.05</b>	<b>0.05</b>	<b>0.05</b>	<b>0.11</b>

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 \$106,000 (2004 - \$165,000) for the third quarter and \$293,000 (2004 - \$340,000) for the nine 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. Current liabilities at December 31, 2005 included \$87,000 (March 31, 2005 - \$6,000) owing to the corporation. Normal commercial rates were paid for these services. Accounts receivable at December 31, 2005 included \$68,000 owing from this same corporation for damage claims incurred on various shipments.

8. Financing Charges

Periods ended December 31	Three months		Nine months	
	2005	2004	2005	2004
(in thousands of dollars)	\$	\$	\$	\$
Interest, short term	41	14	132	48
Foreign exchange losses	15	(2)	87	7
	<b>56</b>	<b>12</b>	<b>219</b>	<b>55</b>

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 December 31	Three months		Nine months	
	2005	2004	2005	2004
(in thousands of dollars, except number of shares)	\$	\$	\$	\$
<b>Numerator:</b>				
<b>Net income available to common shareholders</b>	<b>1,065</b>	<b>1,028</b>	<b>2,129</b>	<b>2,329</b>
<b>Denominator:</b>				
Weighted average shares outstanding - basic	18,008,375	17,797,615	17,981,634	17,626,107
Effect of dilutive securities				
Share options	686,085	620,464	704,497	548,415
Warrants	1,539,226	1,386,968	1,539,861	812,166
<b>Weighted average shares outstanding - diluted</b>	<b>20,233,704</b>	<b>19,805,047</b>	<b>20,226,192</b>	<b>18,986,688</b>

In 2005 and 2004, certain of the warrants were not included in the calculation of diluted shares as the market price was below the performance vesting threshold.







6907 - 36 Street,  
Edmonton, Alberta T6B 2Z6  
1 800 661-8265  
[www.zcl.com](http://www.zcl.com)