

First Quarter
2003



Report

ZCL
COMPOSITES INC.

Message to Shareholders

Notwithstanding the economic slowdown and uncertainty in the past year, the North American petroleum industry is recovering and many companies continue to forecast major capital expenditures for this year. The outlook for the remainder of this year remains positive and our order file is steadily growing. Revenue from other new products, such as the domestic heating oil tank, septic tank, and filament wound pressure vessel, although new to their markets and not as significant as our major product lines, also continues to grow. With the anticipated upturn in our primary markets, we expect to sustain our earnings in our core business over the next year.

Our 2002 year began with record high activity levels in the oil and gas industry, only to see activity in North America decelerate due to lower commodity prices, mergers and acquisitions, and economic uncertainty in the second half of the year. The reduced level of activity in the latter part of last year, where various upgrade and new installation programs in both the upstream and downstream sectors of the petroleum industry were deferred, continued into our first quarter this year. Activity during the quarter was further hindered by weather conditions and a labour dispute at a provincial regulatory agency.

As a result, our revenues for the first quarter decreased by 26% to \$4.9 million from a record level of \$6.6 million last year. Operating earnings this quarter were at a break-even level compared to earnings of \$904,000 last year, and the net loss was \$93,000 (loss of \$0.03 per share) as compared to net earnings of \$387,000 in the first quarter last year (earnings of \$0.02 per share).

Measures taken over the past several years to reduce our costs have allowed us to diminish the impact of a general slowdown in business. We have a solid core liquid storage systems business in Canada. Profitable growth will result from related products, such as tank lining systems, introduced into existing and new markets. Domestic and international markets for the Company's tank manufacturing and lining technologies will continue to be developed by leveraging our customer relationships and innovative industry leadership. Continued success in reducing manufacturing costs and improving production processes will further enhance future profitability.

During the quarter, we completed the acquisition of Mocoat Services Inc., an Alberta-based corporation that provides corrosion prevention services to the oil and

gas industry in Western Canada and manufactures a proprietary patent-pending tank lining or internal secondary containment system. Mocoat also suffered from the low level of activity in the oil and gas market during the quarter. We are taking steps to integrate these operations into our overall liquid storage business and to finalize the development and marketing of our tank lining technologies.

We met with a number of potential investors and financial institutions over the past several months to address the refinancing of the convertible subordinated debenture, which is due on November 30, 2002, and other anticipated financing requirements of the Company. This process, conducted in conjunction with our financial advisor, Capital West Partners, led to our acceptance of the financing proposal from ARC Financial Corporation as announced in our press release on August 8, 2002. This financing sets the stage for us to move to the next level. It is an important step to implement our growth strategy and provides the funds we need to repay the debenture. ARC is the type of partner that understands our industry and our business and shares our vision for the Company. The repayment of the debenture will further contribute to positive results – for this first quarter, the net costs of the debenture were \$216,000 or in excess of \$0.02 per share.

We are pleased with the progress made during this quarter and your Company is better poised than ever to capitalize on the future. New products, a stronger balance sheet and reduced carrying charges will all contribute to better results for quarters and years to come.



Venence G. Côté
President & Chief Executive Officer



Tony G. Barlott
Vice President Finance & Chief Financial Officer

August 9, 2002

Management's Discussion and Analysis

This discussion and analysis should be read in conjunction with the Company's 2002 audited consolidated financial statements and related notes, as well as Management's Discussion and Analysis contained in the 2002 Annual Report and the Message to Shareholders included in this First Quarter Report.

Operating Results

Despite the economic slowdown and uncertainty in the past year, the North American petroleum industry is recovering and many companies continue to forecast major capital expenditures for the remainder of this year. With the anticipated resurgence in the Company's primary markets, earnings in the core business are expected to be sustained over the next year. Historically, the first and fourth quarters have the lowest levels of activity.

Net earnings (loss)

Net loss for the first quarter was \$93,000 as compared to net earnings of \$387,000 in the first quarter last year. After adjusting for the costs of the convertible subordinated debenture (the "debenture"), the basic and diluted loss per share for the quarter was \$0.03 as compared to earnings of \$0.02 per share last year. Stock options and warrants are not included in the calculation of diluted shares as their exercise prices exceeded the average market share price for the periods. The debenture is not included in the calculation of diluted shares as the market share price was below the threshold conversion price of \$3.00.

Revenue

Revenue in the first quarter decreased by 26% to \$4.9 million, from \$6.6 million last year and \$6.5 million in 2000. The reduced level of activity in many industry sectors, which was experienced in the second half of last year, continued in the first quarter of this year. Various upgrade and new installation programs in both the upstream and downstream sectors of the petroleum industry have been deferred because of economic and political uncertainty, commodity price instability and merger and acquisition activity.

Revenue less manufacturing and selling costs

Revenue less manufacturing and selling costs decreased from \$1.7 million (25.6% of revenue) in the first quarter last year, to \$848,000 (17.3% of revenue). This decrease can be attributed to the reduction in revenue. Overall manufacturing margins have been maintained at similar levels as last year, and efforts continue to further improve production processes and reduce costs. The acquisition of Mocoat Services Inc. (“Mocoat”) also contributed to the decrease, as steps are taken to integrate these operations into the overall liquid storage business and finalize the development and marketing of the tank lining technologies.

Amortization

Amortization increased to \$437,000 for the quarter from \$289,000 last year. The increase is due to the amortization of the technology-based intangible asset as a result of the acquisition of Mocoat and the product and market development costs relating to the acquisition of the assets of ZCL-USA, Inc. last year.

The Company adopted the new recommendations of the Canadian Institute of Chartered Accountants with respect to accounting for goodwill effective April 1, 2001, and accordingly, no amortization of goodwill was recorded either this year or last year.

General and administration

General and administration expenses were maintained at the same level as last year. These costs have been reduced through restructuring and cost reduction efforts over the past several years.

Restructuring costs

Restructuring costs of \$98,000 last year (\$Nil this year) related to legal and other costs to review the operations and resolve the dispute with the non-controlling shareholder of ZCL-USA, Inc., including a portion of the amount paid under the acquisition agreement. The restructuring of operations has been completed and no additional costs are anticipated.

Interest

Interest for the quarter increased from \$93,000 last year to \$103,000 this year. While bank indebtedness has decreased from last year, long-term and other debt has increased with the acquisition of Mocoat as described in note 2 to the unaudited consolidated financial statements.

Income taxes

The provision for future income taxes for the first quarter last year included \$145,000 (\$Nil this year) relating to the effect on future tax assets of a reduction in Provincial income tax rates.

Financial Position and Liquidity

Cash was \$1.2 million at June 30, 2002, as compared to cash of \$191,000 at March 31, 2002 and bank indebtedness of \$2.5 million at June 30, 2001. Cash increased by \$1.0 million in the first quarter this year, as compared to a decrease in cash of \$2.7 million for the quarter last year. Due to the timing of cash receipts and payments during the quarter, cash of \$1.4 million was provided by operating activities this year, and cash of \$1.3 million was used in operating activities last year. Cash flows from financing activities this year included \$550,000 of loans from directors, and the repayment of \$200,000 of the debenture, as required by the debenture holder to approve the acquisition of Mocoat. Cash flows from investing activities included \$413,000, including bank indebtedness assumed, for the acquisition of Mocoat this year, and \$996,000 for the acquisition of assets of ZCL-USA, Inc. last year. ZCL Enviro Systems, Inc. made all scheduled payments under the agreement receivable, and \$168,000 was collected in the first quarter.

Working capital decreased to \$6.8 million at June 30, 2002, from \$7.4 million at March 31, 2002 but increased from \$5.6 million at June 30, 2001. The decrease in the first quarter this year is related to the loss during the quarter and the acquisition of Mocoat.

Long-term debt, excluding current portion, increased to \$1.8 million as a result of the acquisition of Mocoat. Total shareholders' equity increased to \$19.5 million, as a result of the issue of common shares for the acquisition of Mocoat, less the loss and net reduction in the debenture for the quarter. The debenture, which is due on November 30, 2002, is anticipated to be refinanced through a combination of conventional debt and equity.

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Consolidated Financial Statements

Consolidated Balance Sheets

(Unaudited)

	June 30 2002	March 31 2002
(in thousands of dollars)	\$	\$
Assets		
Current		
Cash	1,219	191
Accounts receivable	4,468	5,510
Current portion of agreement receivable	1,078	1,016
Inventories	5,457	4,738
Prepaid expenses	212	186
Future tax asset	44	44
	12,478	11,685
Agreement receivable		230
Capital assets	7,338	6,951
Other assets	3,644	2,434
Goodwill	1,926	1,926
Future tax asset	1,813	1,263
	27,199	24,489
Liabilities and Shareholders' Equity		
Current		
Accounts payable and accrued liabilities	3,966	3,304
Income taxes payable	99	97
Notes payable to directors (note 2)	550	
Current portion of long-term debt	911	731
Convertible subordinated debenture – liability portion	200	200
	5,726	4,332
Long-term debt	1,825	1,181
Government grants	188	194
	7,739	5,707
Shareholders' equity		
Capital stock	21,078	20,078
Convertible subordinated debenture – equity portion	7,622	7,635
Contributed surplus	45	45
Deficit	(9,285)	(8,976)
	19,460	18,782
	27,199	24,489

See accompanying notes

Consolidated Statements of Earnings and Deficit

(Unaudited)

Three months ended June 30

	2002	2001
(in thousands of dollars, except share information)	\$	\$
Revenue	4,901	6,607
Manufacturing and selling costs	4,053	4,914
	848	1,693
Amortization	437	289
General and administration	408	402
Restructuring costs		98
Operating earnings	3	904
Interest	103	93
Earnings (loss) before income taxes and non-controlling interest	(100)	811
Income taxes		
Current	8	7
Future (note 3)	(15)	425
	(7)	432
Earnings (loss) before non-controlling interest	(93)	379
Non-controlling interest		(8)
Net earnings (loss) for the period	(93)	387
Deficit, beginning of the period	(8,976)	(9,997)
Convertible subordinated debenture costs, net of future tax benefit	(216)	(199)
Deficit, end of the period	(9,285)	(9,809)
Weighted average shares during the period	9,905,256	9,295,866
Basic and diluted shares outstanding, end of period	10,204,956	9,295,866
Basic and diluted earnings (loss) per share	(\$0.03)	\$0.02

See accompanying notes

Consolidated Statements of Cash Flows

(Unaudited)

Three months ended June 30

(in thousands of dollars)	2002 \$	2001 \$
Cash Flows from Operating Activities		
Cash receipts from customers	6,327	5,556
Cash paid to suppliers and employees	(4,811)	(6,761)
Interest paid	(99)	(70)
Income taxes recovered (paid)	(6)	3
Cash flows from continuing operations	1,411	(1,272)
Cash flows from discontinued operations	(20)	(26)
	1,391	(1,298)
Cash Flows from Financing Activities		
Loans from directors (note 2)	550	
Repayment of long-term debt	(183)	(179)
Repayment of convertible subordinated debenture	(200)	
Convertible subordinated debenture costs	(140)	(142)
	27	(321)
Cash Flows from Investing Activities		
Collection of agreement receivable	168	
Business acquisition, including bank indebtedness assumed (note 2)	(413)	
Acquisition of assets		(996)
Purchase of capital assets	(141)	(63)
Cost of other assets	(4)	(21)
	(390)	(1,080)
Increase (decrease) in cash	1,028	(2,699)
Cash, beginning of the period	191	193
Cash (bank indebtedness), end of the period	1,219	(2,506)

See accompanying notes

Notes to Consolidated Financial Statements

(Unaudited)

June 30, 2002 and 2001

1. Significant Accounting Policies

These unaudited interim consolidated financial statements should be read in conjunction with the March 31, 2002 annual consolidated financial statements. The same accounting policies and methods in accordance with Canadian generally accepted accounting principles are followed as in the March 31, 2002 consolidated financial statements.

2. Business Acquisition

In May 2002, the Company acquired 100% of the shares of Mocoat Services Inc. Mocoat Services Inc. is an Alberta-based corporation that provides corrosion prevention services to the oil and gas industry in Western Canada and manufactures a proprietary patent-pending tank lining or internal secondary containment system.

As part of the approval of this acquisition, the subordinated convertible debenture holder required that the Company raise additional capital, subordinated to their position, in the amount of \$550,000, and make monthly payments of \$100,000 on the debenture commencing in May 2002. Certain directors of the Company loaned the \$550,000 to the Company. The amounts owing are unsecured, bear interest at the annual rate of 25% (10% payable monthly and the balance due at maturity), and are due on December 1, 2002, after the repayment of the debenture.

The acquisition has been accounted for using the purchase method and the consolidated financial statements include the results of operations from May 1, 2002. Details of the aggregate consideration given, including acquisition costs, and the fair value of net assets acquired are as follows:

(in thousands of dollars)	\$
Cash consideration	150
Common share consideration	1,000
Agreement payable	200
Purchase price	1,350

Assets and liabilities acquired at fair values:

Bank indebtedness assumed	(263)
Non-cash working capital	300
Capital assets	417
Other assets – technology	1,479
Long-term debt	(1,007)
Future tax asset	424
Net assets acquired	1,350

Amortization of the technology-based intangible asset is computed using the straight-line method over a period of 5 years.

3. Future Income Taxes

The provision for future income taxes includes \$Nil (2001 – \$145,000) relating to the effect on future tax assets of a reduction in Provincial income tax rates.



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