

Second Quarter  
2003



Report

**ZCL**  
COMPOSITES INC.

# Message to Shareholders

The reduced level of activity in many industry sectors, which was experienced in the second half of last year, continued in the first half of this year. In the second quarter, activity picked up in the downstream sector of the petroleum industry, but remained sluggish in the upstream side due to economic and political uncertainty, commodity price instability and mergers and acquisitions.

Despite the economic conditions and uncertainty in the period, activity in the petroleum industry continues to show signs of recovery. Many companies are forecasting major capital expenditures for the next year. The acquisitions of Mocoat Services Inc. and Parabeam Industries BV, as well as new products introduced in recent years, such as the domestic heating oil tank, are also contributing to overall revenue.

As a result, our revenue for the second quarter decreased by only 1.5% to \$7.7 million from \$7.9 million last year, and by 12.6% to \$12.6 million from \$14.5 million for the six-month period. Net earnings for the second quarter were \$737,000 or \$0.05 per share (\$644,000 or \$0.02 per share for the six-month period) as compared to \$915,000 or \$0.08 per share (\$1.3 million or \$0.10 per share for the six-month period) last year.

Measures we have taken in the past to reduce our costs have diminished the impact of the slowdown in business. Ongoing success in reducing manufacturing costs and improving production processes will enhance future profitability. The repayment of the convertible subordinated debenture, and elimination of the significant related costs, will further contribute to positive results – for the six-month period, the net costs of the debenture were \$461,000 or in excess of \$0.045 per share.

We were very pleased to complete the private placement to ARC Energy Venture Fund 3 during the quarter. This private placement, together with the refinancing of our long-term debt with our banker, CIBC, was used to repay the debenture. ARC is a major shareholder and the type of partner that understands our industry and our business, and shares our vision for the Company.

We continue to work towards finalizing the development and marketing of our tank lining technologies and new tank products. The operations of Mocoat, acquired in the first quarter, are being integrated into our overall business.

During the second quarter, we completed the acquisition of Parabeam, a European-based corporation that manufactures a proprietary three-dimensional glass fabric which is used in the manufacture of our double wall tanks and tank lining products. This fabric is a key component of our products and the acquisition will ensure the supply of this raw material as we move forward with the expansion of our operations.

Our vision for the Company is to be the leading global provider of environmentally-friendly liquid storage solutions. We have a solid liquid storage systems business in Canada. Profitable growth will come from related products introduced into existing and new markets. Domestic and international markets for our tank manufacturing and lining technologies will continue to be developed by leveraging our customer relationships and innovative industry leadership. New products, a strong partner, and a sound balance sheet will all contribute to realize this vision.



Venence G. Côté  
President & Chief Executive Officer



Tony G. Barlott  
Vice President Finance & Chief Financial Officer

# Management's Discussion and Analysis

*This discussion and analysis should be read in conjunction with the Company's March 31, 2002 annual 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 Second Quarter Report.*

## Operating Results

The Company's core business 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 installation of underground liquid storage systems in Canada.

### Net earnings

Net earnings for the second quarter decreased to \$737,000 (\$644,000 for six months) from \$915,000 in the quarter (\$1.3 million for six months) last year. After adjusting for the costs of the convertible subordinated debenture (the "debenture"), the basic and diluted earnings per share for the quarter was \$0.05 (\$0.02 for six months) as compared to \$0.08 for the quarter (\$0.10 for six months) last year. The debenture was fully repaid during the quarter, and these associated costs will not be incurred in the future.

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 second quarter decreased by approximately 1.5% to \$7.7 million (\$12.6 million for six months), from \$7.9 million (\$14.5 million for six months) last year.

In the second quarter, activity picked up in the downstream sector of the petroleum industry, but remained

sluggish in the upstream side because of mergers and acquisitions, economic and political uncertainty and commodity price instability. The acquisitions of Mocoat Services Inc. (“Mocoat”) and Parabeam Industries BV (“Parabeam”), as well as new products introduced in recent years, such as the domestic heating oil tank, contributed to revenue for the quarter.

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

Revenue less manufacturing and selling costs decreased from \$2.3 million, or 29.7% of revenue, in the second quarter (\$4.0 million for six months) last year, to \$2.1 million, or 27.4% of revenue, in the quarter (\$3.0 million for six months) this year. This decrease is due to the reduction in revenue. The acquisition of Mocoat also contributed to the decrease, as steps continued to be taken to integrate these operations into the overall liquid storage business and finalize the development and marketing of the tank lining technologies. Overall manufacturing margins have been maintained at similar levels as last year, and efforts persist to further improve production processes and reduce costs.

### **Amortization**

Amortization increased to \$527,000 for the second quarter (\$964,000 for six months) from \$358,000 for the quarter (\$647,000 for six months) last year. The increase is due to the amortization of assets from the acquisitions of Mocoat and Parabeam, and the product and market development costs relating to the purchase 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 decreased to \$373,000 for the second quarter (\$781,000 for six months) from \$451,000 (\$853,000 for six months) 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 in the first quarter of last year (\$Nil this year) related to ZCL-USA, Inc. The restructuring of operations has been completed and no additional costs are anticipated.

### **Interest**

Interest for the second quarter decreased to \$78,000 (\$181,000 for six months) from \$110,000 (\$203,000 for six months) last year. Over the six-month period, bank indebtedness was lower than last year, offset by an increase in long-term and other debt associated with the acquisition of Mocoat as described in Note 2(a).

Long-term debt was refinanced during the second quarter as described in Note 3(b). Although the Company has taken on some additional bank term debt, the corresponding much higher costs of the debenture have been eliminated.

### **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 \$130,000 at September 30, 2002, as compared to cash of \$191,000 at March 31, 2002 and \$688,000 at September 30, 2001. The Company has not utilized available bank operating lines of credit of \$10.5 million.

Due to the timing of cash receipts and payments during the quarter, cash of \$206,000 was used in operating activities in the second quarter (\$1.2 million provided by operating activities for six months) this year, as compared to cash of \$3.6 million provided by operating activities (\$2.3 million for six months) last year.

Cash flows from financing activities this year reflect the \$7.0 million private placement of common shares and warrants to ARC Energy Venture Fund 3 ("ARC"), the refinancing of bank term debt, and the repayment of the debenture in the second quarter as described in Note 3.

Cash flows from investing activities include the acquisitions of Mocoat and Parabeam this year, and \$996,000 for the acquisition of assets of ZCL-USA, Inc. last year.

ZCL Enviro Systems, Inc. (“Enviro Systems”) paid \$108,000 in the second quarter (\$276,000 over six months) under the agreement receivable. In order to pay off these amounts, Enviro Systems has taken significant steps to reduce costs and improve manufacturing margins in its operations. Management has agreed to the deferral of certain payments under the agreement. While it is expected that this receivable will be collected in full, there is credit risk associated with the collection of this amount.

Working capital increased to \$8.7 million at September 30, 2002, from \$7.9 million at March 31, 2002 and \$7.0 million at September 30, 2001. The increase is related to the profitable operating results over the period.

Long-term debt, excluding current portion, increased to \$4.3 million from \$1.2 million at March 31, 2002 as a result of the acquisition of Mocoat and the refinancing of bank term debt. Total shareholders’ equity increased to \$19.0 million as a result of the issue of common shares relating to the private placement to ARC and the acquisition of Mocoat, the earnings for the period, less the repayment and costs of the debenture.

# Consolidated Balance Sheets

(Unaudited)

	September 30 2002	March 31 2002
(in thousands of dollars)	\$	\$
<b>Assets</b>		
<b>Current</b>		
Cash	130	191
Accounts receivable	7,467	5,510
Current portion of agreement receivable	970	1,016
Inventories	5,350	4,738
Prepaid expenses	179	186
Future tax asset	401	554
	<b>14,497</b>	12,195
Agreement receivable		230
Capital assets	8,241	6,951
Other assets	4,256	2,434
Goodwill	1,926	1,926
Future tax asset	600	753
	<b>29,520</b>	24,489
<b>Liabilities and Shareholders' Equity</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	4,915	3,304
Income taxes payable	88	97
Current portion of long-term debt	739	731
Convertible subordinated debenture – liability portion (note 3c)		200
Future tax liability	34	
	<b>5,776</b>	4,332
Long-term debt (note 3b)	4,291	1,181
Government grants	182	194
Future tax liability	303	
	<b>10,552</b>	5,707
<b>Shareholders' equity</b>		
Capital stock (notes 2a and 3a)	27,378	20,078
Convertible subordinated debenture – equity portion (note 3c)		7,635
Contributed surplus (note 3a)	745	45
Deficit	(9,155)	(8,976)
	<b>18,968</b>	18,782
	<b>29,520</b>	24,489

See accompanying notes

# Consolidated Statements of Earnings and Deficit

(Unaudited)

Periods ended September 30

	Three months		Six months	
	2002	2001	2002	2001
(in thousands of dollars)	\$	\$	\$	\$
<b>Revenue</b>	<b>7,738</b>	7,857	<b>12,639</b>	14,464
Manufacturing and selling costs	<b>5,615</b>	5,526	<b>9,668</b>	10,440
	<b>2,123</b>	2,331	<b>2,971</b>	4,024
Amortization	<b>527</b>	358	<b>964</b>	647
General and administration	<b>373</b>	451	<b>781</b>	853
Restructuring costs				98
<b>Operating earnings</b>	<b>1,223</b>	1,522	<b>1,226</b>	2,426
Interest	<b>78</b>	110	<b>181</b>	203
<b>Earnings before income taxes and non-controlling interest</b>	<b>1,145</b>	1,412	<b>1,045</b>	2,223
<b>Income taxes</b>				
Current	<b>8</b>	7	<b>16</b>	14
Future (note 4)	<b>400</b>	490	<b>385</b>	915
	<b>408</b>	497	<b>401</b>	929
<b>Earnings before non-controlling interest</b>	<b>737</b>	915	<b>644</b>	1,294
Non-controlling interest				(8)
<b>Net earnings for the period</b>	<b>737</b>	915	<b>644</b>	1,302
Deficit, beginning of the period	<b>(9,285)</b>	(9,809)	<b>(8,976)</b>	(9,997)
Common share issue costs, net of future tax benefit (note 3a)	<b>(362)</b>		<b>(362)</b>	
Convertible subordinated debenture costs, net of future tax benefit (note 3c)	<b>(245)</b>	(197)	<b>(461)</b>	(396)
<b>Deficit, end of the period</b>	<b>(9,155)</b>	(9,091)	<b>(9,155)</b>	(9,091)
Weighted average number of shares outstanding – basic and diluted	<b>10,525,322</b>	9,295,866	<b>10,216,983</b>	9,295,866
Shares outstanding, end of the period	<b>17,573,378</b>	9,295,866	<b>17,573,378</b>	9,295,866
Basic and diluted earnings per share	<b>\$0.05</b>	\$0.08	<b>\$0.02</b>	\$0.10

See accompanying notes

# Consolidated Statements of Cash Flows

(Unaudited)

Periods ended September 30

	Three months		Six months	
	2002	2001	2002	2001
(in thousands of dollars)	\$	\$	\$	\$
<b>Cash Flows from Operating Activities</b>				
Cash receipts from customers	5,306	7,544	11,633	13,100
Cash paid to suppliers and employees	(5,391)	(3,841)	(10,202)	(10,602)
Interest paid	(91)	(94)	(190)	(164)
Income taxes paid	(18)	(7)	(24)	(4)
<b>Cash flows from continuing operations</b>	<b>(194)</b>	<b>3,602</b>	<b>1,217</b>	<b>2,330</b>
Cash flows from discontinued operations	(12)	(20)	(32)	(46)
	<b>(206)</b>	<b>3,582</b>	<b>1,185</b>	<b>2,284</b>
<b>Cash Flows from Financing Activities</b>				
Loans from (repayment to) directors (note 2a)	(550)			
Issue of long-term debt (note 3b)	5,000		5,000	
Finance costs (note 3b)	(139)		(139)	
Repayment of long-term debt (note 3b)	(2,706)	(180)	(2,889)	(359)
Issue of common shares and warrants (note 3a)	7,000		7,000	
Common share issue costs (note 3a)	(528)		(528)	
Repayment of convertible subordinated debenture (note 3c)	(7,985)		(8,185)	
Convertible subordinated debenture costs (note 3c)	(208)	(142)	(348)	(284)
	<b>(116)</b>	<b>(322)</b>	<b>(89)</b>	<b>(643)</b>
<b>Cash Flows from Investing Activities</b>				
Collection of agreement receivable	108		276	
Business acquisitions, including bank indebtedness assumed (note 2)	(838)		(1,251)	
Acquisition of assets				(996)
Purchase of capital assets	(37)	(56)	(178)	(119)
Cost of other assets		(10)	(4)	(31)
	<b>(767)</b>	<b>(66)</b>	<b>(1,157)</b>	<b>(1,146)</b>
<b>Increase (decrease) in cash</b>	<b>(1,089)</b>	<b>3,194</b>	<b>(61)</b>	<b>495</b>
Cash (bank indebtedness), beginning of the period	1,219	(2,506)	191	193
<b>Cash, end of the period</b>	<b>130</b>	<b>688</b>	<b>130</b>	<b>688</b>

See accompanying notes

# Notes to Consolidated Financial Statements

(Unaudited)

September 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, except as follows:

### **Change in accounting policy – stock-based compensation**

Effective April 1, 2002 the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants with respect to stock-based compensation and other stock-based payments. As permitted under these recommendations, the Company has applied this change prospectively for new awards granted on or after April 1, 2002. The Company has chosen to recognize no compensation expense when stock options and warrants are granted to employees and directors under plans with no cash or equity settlement features. However, direct awards of shares to employees and non-employees, and awards granted to non-employees, are accounted for in accordance with the fair value method of accounting for stock-based compensation. In periods prior to April 1, 2002, the Company recognized no compensation when shares, stock options or warrants were issued.

The fair value of direct awards of shares are determined by the quoted market price of the Company's shares at the date of grant and the fair value of stock options and warrants are determined, at the date of grant, using the Black-Scholes option pricing model. The following table provides the required pro-forma measures of net earnings and earnings per share had compensation expense been recognized based on the fair value, as at the date of the grant, of the options and performance warrants granted to employees in 2002, in accordance with the fair value method of accounting for stock-based compensation:

## Period ended September 30, 2002:

(in thousands of dollars, except earnings per share)	Three months \$	Six months \$
<b>Net earnings for the period</b>	<b>737</b>	<b>644</b>
Compensation expense	2	2
<b>Pro-forma net earnings for the period</b>	<b>735</b>	<b>642</b>
<b>Earnings per share:</b>		
<b>Reported basic and diluted earnings per share</b>	<b>0.05</b>	<b>0.02</b>
Compensation expense per share	0.00	0.00
<b>Pro-forma basic and diluted earnings per share</b>	<b>0.05</b>	<b>0.02</b>

The estimated fair value of these options and performance warrants was determined using the following weighted-average assumptions, resulting in a weighted-average fair value of \$0.37 per option and \$0.38 per performance warrant:

Risk-free interest rate (%)	4.0
Expected hold period to exercise (years)	options 4.0 / performance warrants 5.0
Volatility in the price of the Company's shares (%)	options 61.6 / performance warrants 56.2
Dividend yield (%)	0.0

## 2. Business Acquisitions

### a) Mocoat Services Inc.

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 convertible subordinated 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 in May 2002. The amounts

## 2. Business Acquisitions *(continued)*

### a) Mocoat Services Inc. *(continued)*

owing were unsecured, bore interest at the annual rate of 25% (10% paid monthly and the balance at maturity), and were due on December 1, 2002, after the repayment of the debenture. These amounts were repaid in September 2002.

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
<b>Purchase price</b>	<b>1,350</b>

#### Assets and liabilities acquired at fair values:

Bank indebtedness assumed	(263)
Non-cash working capital	300
Capital assets	417
Other assets – technology	2,244
Long-term debt	(1,007)
Future tax liability – net	(341)
<b>Net assets acquired</b>	<b>1,350</b>

Amortization of the technology-based intangible asset is provided for on a straight-line basis over a period of 5 years.

The initial purchase price allocation has been adjusted to reflect the future income tax liability for the taxable temporary difference arising from the technology-based intangible asset which is not deductible for income tax purposes. This adjustment had no effect on earnings for the period.

### b) Parabeam Industries BV

In September 2002, the Company acquired 100% of the shares of Parabeam Industries BV. Parabeam is based in The Netherlands and manufactures a three-dimensional glass fabric that is used by the Company in the manufacture of double wall tanks and tank lining products.

The acquisition has been accounted for using the purchase method and the consolidated financial statements include the results of operations from September 9, 2002. Cash consideration for the purchase was \$1,225,000, including costs relating to the acquisition and relocation of the operations to new premises. Accounts payable and accrued liabilities at September 30, 2002 include \$387,000 of accrued acquisition and relocation costs. The fair value of assets and liabilities acquired is as follows:

(in thousands of dollars)	\$
Non-cash working capital	527
Capital assets	1,038
Future tax liability	(340)
<b>Net assets acquired</b>	<b>1,225</b>

Amortization of the acquired capital assets is provided for on a declining balance basis at an annual rate of 10%.

### 3. Financing

#### a) Capital Stock

In September 2002, the Company completed a private placement to ARC Energy Venture Fund 3 of 7,368,422 units ("Unit") at \$0.95 per Unit for total cash proceeds of \$7,000,000.

Each Unit was comprised of one common share of the Company and 0.5 Performance Warrants ("Warrant"). Each whole Warrant entitles the holder to subscribe for one common share at a price of \$0.95 for a period of up to five years subject to a performance vesting provision. The Warrants vest at one-third intervals upon the weighted-average trading price of common shares reaching thresholds, for a period of twenty trading days, of \$1.90, \$2.85 and \$3.80 per common share. One-half of the Warrants are segregated for transfer to senior management of the Company.

Of the total cash proceeds, \$700,000 was attributed to the value of the Warrants and allocated to contributed surplus. Issue costs of \$548,000, less future tax benefit of \$186,000, were charged to deficit.

### **3. Financing** *(continued)*

#### **b) Long-Term Debt**

In September 2002, the Company arranged a bank term loan in the amount of \$5,000,000 and repaid the majority of previous long-term debt outstanding at the time.

The bank term loan bears interest at bank prime rate plus 0.50% per annum (the interest rate applied at September 30, 2002 was 5.0%), and is repayable in quarterly instalments of \$178,572 (based on a seven-year amortization) with a final payment of the full balance due in three years from the date of drawdown. It is anticipated that the repayment will be extended so that the loan will actually be repaid over seven years.

Finance costs of \$209,000 were capitalized as deferred finance charges and included in other assets. These costs are amortized on a straight-line basis over a period of 7 years.

#### **c) Convertible Subordinated Debenture**

In September 2002, the convertible subordinated debenture was repaid in full. The debenture bore interest at 9.75%, plus an accretion of 8.25% per annum, and was due on November 30, 2002.

A make-whole premium based on the present value, over the period remaining to maturity of the debenture, of the difference between the debenture interest rate of 9.75% and the lender's reinvestment rate of return, was payable on amounts repaid. The make-whole premium on the repayment of the debenture was \$56,000.

### **4. 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.

### **5. Comparative Figures**

Certain comparative figures have been reclassified to conform with the presentation adopted for the current period.

**Transfer Agent & Registrar**

Computershare Trust Company of Canada  
Edmonton, Alberta

**Auditors**

Ernst & Young LLP  
Edmonton, Alberta

**General Counsel**

Parlee McLaws  
Edmonton, Alberta

**Stock Listing and Share Symbol**

Toronto Stock Exchange: **ZCL**



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