



**Xebec Adsorption Inc.**

**Management Discussion and Analysis  
For the Six-Month Period ended June 30, 2009**

Additional information relating to the Company can be found on SEDAR at [www.sedar.com](http://www.sedar.com).

The following management discussion and analysis ("MD&A"), dated August 12, 2009, relates to our interim consolidated financial statements for the three-month and six-month periods ended June 30, 2009. The MD&A should be read in conjunction with the Company's interim consolidated financial statements and related notes therein that are prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP").

All financial information is stated in Canadian dollars, unless otherwise indicated. Additional information regarding Xebec Adsorption Inc. ("Xebec" or "the Company") can be found on the System for Electronic Document Analysis and Retrieval (SEDAR) at [www.sedar.com](http://www.sedar.com).

Management prepared this MD&A taking into account all available information as at August 12, 2009. The consolidated financial statements and the MD&A were reviewed by the Audit Committee and approved by the Board of Directors of Xebec Adsorption Inc.

### **Forward Looking Statements**

This MD&A contains forward-looking statements, including statements regarding the future success of our business, technology, and market opportunities. Forward-looking statements typically contain words such as "believes", "expects", "anticipates", "continue", "could", "indicates", "plans", "will", "intends", "may", "projects", "schedule", "would" or similar expressions suggesting future outcomes or events, although not all forward-looking statements contain these identifying words. Examples of such statements include, but are not limited to, statements concerning: (i) expectations regarding the Company's future success in the biogas and other markets; (ii) the key market drivers and other factors that are expected to impact the Company's performance; (iii) future financial results; (iv) the expected actions of the third parties described herein; and (vi) the business and financial outlook of the Company, for fiscal 2009. In addition, this MD&A contains financial outlook information that is intended to provide general guidance for readers based on management's current estimates, but which is based on numerous assumptions that may prove to be incorrect and, therefore, such financial outlook information should not be relied upon by readers. These statements are neither promises nor guarantees, but involve known and unknown risks and uncertainties that may cause our actual results, level of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed in or implied by these statements. These risks include, but are not limited to, risks related to revenue growth, operating results, industry and products, technology, competition, foreign exchange rates, general economic conditions and those factors described in detail herein under the heading 'Risks & Uncertainties'.

The forward-looking statements contained herein are also based on assumptions that management believes are current and reasonable, including but not limited to, assumptions regarding: (i) trends in certain market segments and the economic climate generally; (ii) the financial strength of our customers; and (iii) the value of the Canadian dollar. The Company cannot assure readers that actual results will be consistent with the statements contained in this MD&A. The forward-looking statements and financial outlook information contained herein are made as of the date of this MD&A and are expressly qualified in their entirety by this cautionary statement. Except to the extent required by law, the Company undertakes no obligation to publicly update or revise any such statements to reflect any change in our expectations or in events, conditions, or circumstances on which any such statements may be based, or that may affect the likelihood that actual results will differ from those described herein.

## **ABOUT XEBEC ADSORPTION INC.**

Xebec specializes in the design and manufacture of cost-effective, environmentally responsible purification, separation, dehydration, and filtration equipment for gases and compressed air. The solutions we provide include natural gas and biogas purification, natural gas dehydration, hydrogen purification for fuel cell and industrial applications, and specialized solutions for other gases. Xebec also offers compressed air treatment solutions. To-date, Xebec has supplied more than 8,000 adsorption systems to more than 1,300 customers worldwide. Xebec is headquartered in Blainville, Quebec, Canada and its shares trade on the TSX under the symbol "XBC". More information can be found at [www.xebecinc.com](http://www.xebecinc.com).

Xebec is a manufacturer of gas purification and dehydration systems for clean energy, hydrogen and renewable natural gas. It results from the amalgamation with QuestAir Technologies Inc. ("QuestAir") on June 12, 2009. The comparative financial statements are those of Xebec and the financial statements reflect the accounts of QuestAir from June 12, 2009.

The unaudited interim consolidated financial statements include the accounts of the wholly-owned subsidiary, Xebec Adsorption Shanghai Co. LTD. ("Xebec China"). They also include the Company's 40% portion of the accounts of Xebec Adsorption South East Asia PTE. LTD. ("Xebec Singapore"), a joint venture accounted for using the proportionate consolidation method.

### **Significant Event**

#### **Business Combination**

Pursuant to the combination agreement between Xebec and QuestAir, the shareholders of Xebec (the "Vendors") sold all of the issued and outstanding shares in the capital of Xebec to QuestAir in exchange for up to an aggregate of 15,241,976 common shares in the capital of QuestAir and 6,180,000 warrants of QuestAir. As a result of this transaction, the Vendors have received enough common shares of QuestAir to effect a reverse takeover of QuestAir. Accordingly, the financial statements of the Company reflect the accounts of QuestAir from June 12, 2009. The comparative financial statements included in these unaudited interim consolidated financial statements are those of Xebec. Subsequent to that transaction, QuestAir and Xebec have amalgamated and have continued as one corporation under the name of Xebec Adsorption Inc.

At the time of closing of the arrangement, the Vendors were issued 9,407,727 common shares, resulting in the Vendors' initially controlling 45% of the outstanding common shares of the amalgamated company. The Vendors may increase their holdings in the amalgamated company by up to 5,834,249 common shares, resulting in an increase in the Vendors' holdings from 45% to 57% pursuant to the earn-out provisions contained in the combination agreement if certain adjusted EBITDA performance targets are achieved by the amalgamated company following completion of the arrangement (in respect of the 2009 and 2010 fiscal years). These shares issued by QuestAir on completion of the arrangement are currently held in escrow.

The acquisition is accounted for using the purchase method of accounting. This method requires the determination of the aggregate purchase price, estimated at \$13,068,076, for the net assets of QuestAir and allocation of this amount to assets acquired and liabilities assumed based on their estimated fair value.

The following table represents the estimated fair value of the assets acquired and liabilities assumed on the effective acquisition date. The excess of the purchase price over the net identifiable assets acquired is preliminarily allocated to goodwill on the unaudited interim consolidated balance sheet. Management intends to complete a formal valuation of the tangible and intangible assets acquired and liabilities assumed, including tax loss carryforwards amounting to \$20.8 million, in order to finalize allocation of the total purchase price.

Also as a result of this acquisition, Management began to assess and formulate a plan to realize potential synergies.

	\$
<b>Assets acquired</b>	
Cash and cash equivalents	5,122,028
Accounts receivable – net	1,455,301
Inventories	2,438,766
Prepaid expenses	173,354
Property, plant and equipment	939,223
Goodwill	5,850,851
Restricted cash	<u>62,600</u>
 Total assets	 <u>16,042,123</u>
<b>Liabilities assumed</b>	
Accounts payable and accrued liabilities	1,519,032
Deferred revenues	<u>1,455,015</u>
 Total liabilities	 <u>2,974,047</u>
 <b>Net assets acquired</b>	 <u>13,068,076</u>
<b>Consideration</b>	
11,269,318 Common shares, 6,180,000 warrants and 199,347 stock options	12,000,000
Acquisition costs	<u>1,068,076</u>
	<u>13,068,076</u>

Following the completion of the transaction with QuestAir on June 12, 2009, the Company began the process of executing its restructuring plan to realize potential synergies. Going forward, the Burnaby (BC) facility will remain focused on research and development as well as engineering service contracts. All manufacturing, and most sales and administration will be centralized at the Blainville (QC) facility, resulting in a reduction of 18 people in the Burnaby (BC) workforce. Management expects the integration plan to be completed by the end of 2009. As part of capitalizing on the available synergies, Andrew Hall, the former CEO of QuestAir, and currently VP sales and business development of the merged company, will relocate to China and take over full responsibility for the further successful development of our business in Asia/Pacific. The Asian/Pacific region offers Xebec excellent growth opportunities in the industrial and clean tech area.

Xebec, the merged company, brings together complementary gas purification technologies, global distribution networks in high growth markets in North America, Asia and Europe, and low-cost manufacturing and supply chain capabilities. The Company will immediately leverage all

available synergies to expand its market share in clean energies, such as natural gas dehydration, biogas upgrading and hydrogen purification.

With almost \$5 million in cash as at June 30, 2009, Xebec is well positioned to execute its long-term strategic plan.

## **REVIEW OF OPERATIONS**

The following review of Xebec's financial results for the six month period ended June 30, 2009 include the results of its wholly-owned subsidiary, Xebec Adsorption Shanghai Co. LTD. ("Xebec China"), which commenced operations in the fourth quarter of 2008; and two weeks of contribution from QuestAir's gas purification and engineering services. In January 2009, Xebec, through its affiliate Xebec Adsorption South East Asia PTE. LTD. ("Xebec Singapore"), opened a regional sales office in Singapore to serve its Southeast Asian customers and support its planned expansion in the region.

### **Financial Overview**

- Transaction with QuestAir was completed on June 12, 2009, with net assets acquired of \$13.1 million including \$5.1 million of cash.
- Revenue was \$4,303,256 for the second quarter, a decrease of \$395,900 from the same period in fiscal 2008. Revenue for the six months was \$9,010,635, a year-over-year increase of \$2,290,173. Second quarter revenues were impacted by weak economic conditions in North America, offset by strong gains in Asia.
- Net loss was \$677,237 or \$0.06 per share for the second quarter, compared to net income of \$200,724 or \$0.02 per share a year earlier. Net loss for the six months was \$482,559 or \$0.05 per share, compared to a net loss of \$308,414 or \$0.04 per share for the same period in 2008. The net loss for the quarter and the six-month period ended June 30, 2009 include an amount of \$229,579 for non-cash compensation expense related to the performance-based share awards issued with the transaction.
- Gross margins in the second quarter increased significantly to \$1,674,117 or 39%, from \$1,549,015 or 33% in the same period in fiscal 2008. The significant improvement is a result of synergies realized by manufacturing high quality products at a low cost in China.

### **Results of Operations**

#### ***Revenues***

(Unaudited)	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Natural Gas Dryers	3,062,626	3,383,988	6,583,214	4,572,840
Compressed Gas Filtration	679,157	966,751	1,273,440	1,677,576
Air Dryers	245,847	348,417	838,355	469,996
Gas Purification	93,071	-	93,071	-
Engineering Services	222,555	-	222,555	-
Revenue	4,303,256	4,699,156	9,010,635	6,720,462

For the second quarter ended June 30, 2009, total revenues of \$4,303,256, were slightly lower than in the second quarter of 2008. Revenues from natural gas dryers remained relatively stable year over year as a result of stronger demand in the Asian markets, while revenues from compressed gas filtration units and air dryers were impacted by weaker conditions in the North American market. First-time revenues from gas purification units and engineering services in the second quarter of 2009 reflect the two-week contribution from QuestAir, which merged with Xebec on June 12, 2009.

For the six-month period, revenues amounting to \$9,010,635 now include sales from our Shanghai facility, which commenced operations in the last quarter of 2008. Compared to the same period in 2008, revenues in the first half of 2009 increased by \$2,290,173 or 34%.

The total sales order backlog as of June 30, 2009 was approximately \$10.6 million.

### **Gross Profit**

(Unaudited)	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Sales	4,303,256	4,699,156	9,010,635	6,720,462
Cost of goods sold	2,629,139	3,150,141	5,523,625	4,704,293
Gross Profit	1,674,117	1,549,015	3,487,010	2,016,169
Gross Margin (%)	39%	33%	39%	30%

Gross profit increased significantly to \$1,674,117 for the quarter and \$3,487,010 for the six months ended June 30, 2009. This improvement is a result of synergies realized by manufacturing high quality products at a low cost in China.

Profits and corresponding margins are expected to fluctuate from quarter to quarter depending on the mix of revenues recognized from higher-margin engineering service contracts and gas purification systems.

### **Selling and Administrative**

Selling and administrative expenses were \$2,089,720 for the second quarter of fiscal 2009, compared to \$1,054,500 for the same period in fiscal 2008. Selling and administrative expenses were \$3,461,567 for the six months ended June 30, 2009, compared to \$2,026,595 for the same period in fiscal 2008. An amount of \$229,579 for non-cash compensation related to the performance-based share awards is included in selling and administrative expenses for the quarter and the six-month period ended June 30, 2009. Expenses from our operations in Shanghai, in Burnaby (BC) from June 12 to June 30, 2009 and our share in the joint venture in Singapore also contributed to the increase compared with the corresponding periods of the previous year.

### **Financial**

Financial expense decreased to \$46,908 in the second quarter and \$116,388 in the six months ended June 30, 2009 as a result of lower interest rates and a reduction in long-term debt.

### **Foreign Exchange Loss**

The foreign exchange loss was \$213,256 in the second quarter and \$202,158 in the six months ended June 30, 2009. The year-over-year increase was primarily due to the strengthening of the CAD vs EUR, resulting in a decrease of \$157,605 in the derivative assets for the quarter ended June 30, 2009.

### **Amortization**

Amortization expense increased to \$105,085 in the second quarter and \$187,469 in the six months ended June 30, 2009 compared with the previous year, as a result of the addition of the manufacturing facility in China.

### **Net Loss**

Net loss for the quarter ended June 30, 2009 was \$677,237 or \$0.06 per share, compared to net income of \$200,724 or \$0.02 per share in 2008. Net loss for the six months ended June 30, 2009 was \$482,559 or \$0.05 per share, compared to a net loss of \$308,414 or \$0.04 per share in fiscal 2008. The net loss for the quarter and the six-month period ended June 30, 2009 include an amount of \$229,579 for non-cash compensation expense related to the performance-based share awards issued with the transaction.

## Summary of Quarterly Results

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	Year ending December 31, 2009		Year ended December 31, 2008				Year ended December 31, 2007	
	June 30	March 31	Restated Dec. 31	Restated Sept.	Restated June 30	Restated March 31	Dec. 31	Sept. 30
	\$	\$	\$	\$	\$	\$	\$	\$
Revenues	4 303 256	4 707 379	7 434 653	2 685 507	4 699 156	2 021 306	2 421 718	2 362 458
Net income (loss)	(677 237)	194 677	1 104 476	50 096	200 724	(509 138)	(464 882)	132 376
Earnings (loss) per share basic and diluted	(0.06)	0.02	0.13	0.01	0.02	(0.06)	(0.05)	0.02

Given the early stage of Xebec's development, fluctuations occur in operating results from quarter to quarter and this trend is expected to continue for the foreseeable future.

### Balance Sheet Items

#### **Assets**

Total assets as at June 30, 2009 were \$24,241,629, an increase of \$13,567,594 from the December 31, 2008 amount of \$10,674,035. At the end of June 30, 2009, Xebec had \$4,927,017 in cash compared with \$550,377 as at December 31, 2008. Xebec's inventories increased from \$2,579,877 as at December 31, 2008 to \$5,513,669 as at June 30, 2009. Goodwill amounted to \$5,850,851 as at June 30, 2009. These increases result from the completion of the transaction with QuestAir on June 12, 2009 as described in note 5 of the financial statements.

#### **Liabilities**

Total liabilities at June 30, 2009 were \$11,356,017 representing an increase of \$1,807,123 from the December 31, 2008 amount of \$9,548,484. The increase is mainly a result of the completion of the transaction with QuestAir as previously mentioned. This was partially offset by a reduction of the bank loan amounting to \$1,105,563.

#### **Equity**

Xebec's net equity as at June 30, 2009, was \$12,885,612, including an increase of \$12,000,000 in share capital following the transaction with QuestAir. Contributed surplus also increased to \$243,030 mainly because of the accounting for non-cash compensation expense related to performance-based share awards.

#### **Credit Facilities**

The Company has access to credit facilities in the amount of \$1,500,000, which bear interest at the Company's bank's prime rate plus 0.60% per annum. The Company also has access to credit facilities in the amount of \$208,906, which bear interest at the Company's bank's prime rate plus 3.55% per annum. These credit facilities are limited by certain margin requirements concerning accounts receivable. In addition, the Company has access to credit facilities in the amount of \$500,000, which bear interest at the Company's bank's prime rate plus 1.50% per annum and are limited by certain requirements concerning pre-shipment costs. The bank loan is secured by a first ranking hypothec of \$4,500,000 on all moveable property of the Company. The Company must also comply with certain covenants requiring a minimum current ratio and

maximum funded debt to tangible net worth. As at June 30, 2009, the Company is in compliance with the covenants.

As well, the Company has access to a revolving demand facility in the amount of \$1,000,000 by way of letters of credit and letters of guarantee.

Xebec's credit facilities and financing agreements mature on various dates. There can be no assurance that such credit facilities or financing agreements will be renewed or refinanced, or if renewed or refinanced, that the renewal or refinancing will occur on equally favourable terms to Xebec. Xebec's ability to continue operating may be adversely affected if Xebec is not able to renew its credit facilities or arrange refinancing, or if such renewal or refinancing, as the case may be, occurs on terms materially less favourable to Xebec than at present. Xebec's current credit facilities and financing agreements impose covenants and obligations on Xebec. There is a risk that such loans may go into default if there is a breach in complying with such covenants and obligations, which could result in the lenders realizing on their security and causing the shareholders to lose some or all of their investment.

### Cash Flows

The Company's cash flows from operating, investing and financing activities, as reflected in the consolidated statements of cash flows, are summarized in the following table:

(in thousands of Canadian dollars)

	<b>For the three-month periods ended June 30,</b>		
	<b>2009</b>	<b>2008</b>	<b>Change</b>
	\$	\$	\$
Cash provided by operating activities	700	264	436
Cash provided (used) by investing activities	4,248	(62)	4,186
Cash provided (used) by financing activities	(223)	197	420

(in thousands of Canadian dollars)

	<b>For the six-month periods ended June 30,</b>		
	<b>2009</b>	<b>2008</b>	<b>Change</b>
	\$	\$	\$
Cash provided by operating activities	1,628	(821)	807
Cash provided (used) by investing activities	3,875	(88)	3,963
Cash provided (used) by financing activities	1,126	851	1,977

As a result of the transaction completed on June 12, 2009, cash provided by investing activities increased by more than \$4 million for both the quarter and the six-month period ended June 30, 2009. The Company's goal is to preserve its cash position by staying cash flow positive.

Xebec's growth is financed through a combination of working capital, borrowing under existing credit facilities, increasing long-term debt wherever suitable, and eventually issuing equity if appropriate. The Company will strive to maintain optimal level of liquidity through active management of its assets, liabilities, and cash flows.

### **Contingent Off-Balance Sheet Financing Arrangements**

Prior to the transaction on June 12, 2009, QuestAir received funding contributions from various programs of the Canadian Government to support the development and commercialization of our gas purification technology. The Company did not enter into any new contingent off-balance sheet financing arrangements during the quarter ended June 30, 2009.

A summary of these funding arrangements is provided in the tables below:

#### **Technology Partnerships Canada (TPC)**

At September 30, 2008, QuestAir had received \$8,139,937 under a conditionally repayable loan under the TPC funding program, through an agreement administered by Industry Canada. These funds are repayable in the form of annual royalties under certain conditions. During the year QuestAir finalized negotiations with TPC to amend this agreement to, among other things, eliminate certain development milestones, extend the program completion date for certain other milestones, and reduce the contribution amount and the associated royalties. Amounts drawn under this contribution agreement are subject to final audit by Industry Canada. QuestAir entered into a similar funding arrangement with TPC in 1999 and received a total of \$4,762,503 in funding from March 1999 to July 2002. The funding is also repayable under certain conditions. The repayment obligations and total royalty repayments made to date for these funding programs are listed below:

<b>Funding Award Date</b>	<b>Description</b>	<b>Royalties</b>	<b>Term</b>	<b>Royalty Payments to Date</b>
June 6, 2003	Fast Cycle Pressure Swing Adsorption	Annual royalties of 1.165% of gross business revenues	The royalty period began on October 1, 2005 and will end on the earlier of September 30, 2022 or until a cumulative royalty ceiling of \$18.8 million is reached.	Total cumulative payments: \$797,767 Accrued for future payment: \$164,101
March 31, 1999	Pulsar Pressure Swing Adsorption Program	Annual royalties of 1.8% of gross project revenues and fuel cell related products	Royalty period extends to the later of the date of payment of all amounts due to the Minister and 2015. The maximum cumulative repayment is \$8.75 million.	Total cumulative payments: \$56,726 Accrued for future payment: \$0

#### **Department of Natural Resources Efficiency and Alternative Energy Program**

In 2005, QuestAir were awarded a grant for \$225,000 from the Government of Canada under the Department of Natural Resources Efficiency and Alternative Energy Program. In 2004, QuestAir received a similar funding award of \$193,944 under the same funding program. Both funding awards are repayable under certain conditions. The repayment obligations and total royalty repayments made to date for these funding programs are listed below:

<b>Funding Award Date</b>	<b>Description</b>	<b>Royalties</b>	<b>Term</b>	<b>Royalty Payments to Date</b>
January 4, 2005	Development of structured adsorbent for the production of high purity hydrogen	Annual royalties of 0.12% of gross project revenues	Royalty period starts on date of first gross project revenues and extends to March 31, 2015, to a maximum cumulative repayment of \$225,000, whichever occurs first.	Total cumulative payments: \$5,592 Accrued for future payment: \$0
January 6, 2004	Development of a device that increases the efficiency of a high temperature fuel cell system	Annual royalties of 0.12% of gross project revenues	Royalty period starts on date of first gross project revenues and extends to March 31, 2014, to a maximum cumulative repayment of \$193,944, whichever occurs first.	Total cumulative payments: \$0 Accrued for future payment: \$0

## **Outstanding Share Data**

### **Common Shares**

Pursuant to the accounting standards applicable to reverse takeovers, a total of 8,638,496 common shares were deemed to be issued and outstanding prior to the transaction. On June 12, 2009, upon conversion of 300,000 preferred shares of former Xebec Adsorption, 769,231 common shares were issued to a shareholder of Xebec. On June 12, 2009 upon the reverse takeover, an additional 11,269,318 common shares, representing the common shares historically issued to the shareholders of QuestAir, were deemed to have been issued by the Company.

As at June 30, 2009 the Company had 20,677,045 common shares issued and outstanding. As a result of the business combination (described in note 5 of the financial statements), the Company issued 5,834,249 common shares which are held in escrow as at June 30, 2009. These shares could be released to the former Xebec shareholders on the achievement of specified financial targets. These targets will be measured at December 31, 2009 and 2010. Consequently, these shares are considered restricted share awards that are issued but not outstanding. Stock-based compensation is recorded based on management's best estimate of the ultimate achievement of the financial targets over the vesting periods, namely until December 31, 2009 and 2010.

Pursuant to the transaction, the authorized share capital of the Company consists of an unlimited number of common shares and an unlimited number of preferred shares. No preferred shares are issued.

As at August 12, 2009, the number of common shares issued was 26,511,294, including 5,834,249 common shares held in escrow, described above.

### **Share purchase warrants outstanding**

As at June 30, 2009, 12,360,000 warrants were outstanding, of which 12,180,000 warrants entitle the holder to acquire one additional common share per warrant at a price of \$2.15 until May 13, 2010. The remaining 180,000 warrants entitle the holder to acquire one common share per warrant at a price of \$1.50 until May 13, 2010. The ability to exercise the 6,180,000 warrants issued on the reverse takeover transaction is contingent on the exercise of the remaining pre-existing warrants.

### **Stock Options Outstanding**

Upon the reverse takeover, the Company assumed QuestAir's stock option plan (the "Plan"), which allows for the issuance of stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards and other stock-based awards. Under the Plan, common shares approved for issuance under all stock-based compensation arrangements are limited to the greater of 591,560 and 10% of the common shares issued and outstanding. As at June 30, 2009, the maximum number of common shares available for issuance under all stock-based compensation arrangements is 2,445,548.

Under the terms of the Plan, stock options are granted with an exercise price not less than the volume weighted average trading price of the common shares for the five trading days prior to the date of grant. Stock options generally vest quarterly over four years and are exercisable for seven years from the date of grant.

As at June 30, 2009 the Company had 175,523 options outstanding under the plan with a weighted average exercise price of \$5.12.

## **Outlook**

Despite the strong financial performance through the first half of fiscal 2009, the Company continues to face challenging conditions in its target product markets as a result of the global economic condition. With the recent commencement of operations in China, the Company is realizing significant cost savings with its state-of-the-art manufacturing facility and increased sales from the Asian region. While interest in the biogas upgrading market remains high, the pace of project development in the biogas market remains slow due to depressed natural gas prices and challenging conditions in the debt market for financing renewable energy projects.

The merger completed on June 12, 2009 with QuestAir provides Xebec with a solid platform for the next phase of growth. Xebec has built a successful and strong business, with loyal customers and a global footprint. Our merger with QuestAir will help us pursue leadership positions in growing sectors such as biogas purification, specialized gas filtration, natural gas dehydration, and hydrogen purification. Currently these segments provide an addressable market of over \$500 million annually and represent a compelling business opportunity.

The merger will enable Xebec to optimize its technologies to make further inroads in the fast-growing market for Compressed Natural Gas ("CNG") as a vehicle fuel, including renewable CNG produced from biogas, currently the only carbon neutral fuel available for immediate deployment. In the United States, natural gas vehicle fuel consumption has more than tripled in the past decade, from 793 million cubic feet in December 1998 to 2.5 billion cubic feet in December 2008. In addition, the adoption of CNG vehicles has been rapid in some developing countries, and there are now more than seven million natural gas vehicles worldwide. Compressed natural gas is gaining ground as an affordable, low-carbon fuel alternative that produces significantly lower levels of greenhouse gases than oil-based gasoline and diesel.

Looking forward, the longer term outlook for the biogas industry remains bright. As an example, in March 2009 the Government of Quebec announced a \$500 million program for the construction of anaerobic digestion projects by municipalities in Quebec to process municipal waste. The project is specifically geared towards the production of pipeline-quality biomethane from these municipal waste sources. Management is optimistic that, once implemented, this program has the potential to drive the development of a number of biogas upgrading and pipeline injection projects in the province of Quebec.

Likewise in the U.S. market there are a number of proposed government initiatives such as the New Alternative Transportation to Give Americans Solutions (NAT GAS) Act that support the use of CNG as a domestic, clean transportation fuel. These initiatives have the potential to be a direct driver of Xebec's sales of natural gas dryers for CNG infrastructure, as well as being an indirect stimulus for the development of biogas-to-CNG projects to provide a renewable source of CNG supply.

## **Critical Accounting Policies and Estimates**

### **Critical Accounting Estimates**

Financial statements prepared in accordance with Canadian GAAP require management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### **Warranty Provision**

During the normal course of its operations, Xebec assumes certain maintenance and repair costs under warranties offered on dryers and filters. The warranties cover a period ranging from twelve to eighteen months. A liability for the expected cost of the warranty-related claims is established when the product is delivered and completed. In estimating the warranty liability, historical

material replacement cost and the associated labour costs are considered. Revisions are made when actual experience differs materially from historical experience.

### **Revenue Recognition**

Revenues from long term production-type contracts and engineering service contracts are determined under the percentage-of-completion method whereby revenues are recognized on a pro rata basis in relation to contract costs incurred. Costs and estimated profit on contracts in progress in excess of amounts billed are reflected as work-in-progress. Cash received in advance of revenues being recognized on contracts is classified as deferred revenue.

### **Stock-based Compensation Plans**

The Company accounts for stock options using the fair value method calculated using the Black-Scholes option pricing model. For options granted to directors, officers and employees, the compensation cost is measured at fair value at the date of grant and is expensed to operations over the award's vesting period. For options granted to non-employees, the fair value is measured when performance is complete, a performance commitment is made or the options are fully vested and non-forfeitable, whichever is earliest, and the expense is recognized over the period in which the goods or services from the non-employees are received. A corresponding increase in contributed surplus is recorded when stock options are expensed. When stock options are exercised, capital stock is credited by the sum of the consideration paid and the related portion previously recorded in contributed surplus. The effects of forfeitures are accounted for as they occur.

### **Foreign Operations**

The Company's foreign operations are defined as integrated and are translated using the temporal method. Under this method, monetary assets and liabilities are translated into Canadian dollars at the rate of exchange prevailing at the balance sheet date and non-monetary assets and liabilities at rates prevailing at the transactions dates. Revenues and expenses (other than amortization, which is translated at the rate applicable to the related asset) are translated at average rates for the year. Gains and losses arising on translation are included in the statement of earnings for the period.

### **Changes in Accounting Policies Including Initial Adoption**

On January 1, 2009, the Company adopted Canadian Institute of Chartered Accountants ("CICA") Section 3064, "Goodwill and Intangible Assets", which replaces Section 3062, "Goodwill and Other Intangible Assets", and which resulted in (i) the withdrawal of Section 3450, "Research and Development Costs" and Emerging Issues Committee Abstract 27, "Revenues and Expenditures During the Pre-operating Period", and (ii) the amendment of Accounting Guideline 11, "Enterprises in the Development Stage". This new standard provides guidance on the recognition of intangible assets in accordance with the definition of an asset and the criteria for asset recognition, whether those assets are separately acquired or internally developed, as well as clarification on the application of the concept of matching revenues and expenses. The adoption of Section 3064 eliminated the deferral of start-up costs, which are now recognized as an expense when they are incurred. Consequently, the Company adjusted opening retained earnings as if the new rules had always been applied in the past and the prior period figures have been restated. As well, the Company made reclassifications in order to present certain assets, mainly software, as intangible assets instead of presenting them as property, plant and equipment.

As a result of the adoption of these new rules, the following tables summarize the adjustments that were recorded in the unaudited interim consolidated financial statements:

	<b>As at December 31, 2008 \$</b>
<b>Balance sheet</b>	
Increase (decrease) in	
Property, plant and equipment	(143,619)
Intangible assets	(446,022)
Future income tax liabilities	16,424
Retained earnings	(573,217)

### **International Financial Reporting Standards (IFRS)**

The AcSB announced that accounting standards in Canada are to converge with IFRS. The changeover date from current Canadian GAAP to IFRS has been established as January 1, 2011. While IFRS use a conceptual framework similar to Canadian GAAP, there are significant differences in accounting policy which must be addressed.

A diagnostic assessment will be initiated in the third quarter of 2009 to examine the extent of the impact that the conversion may have on financial reporting, business processes and information systems. The Company's current plan is aimed in particular at identifying the differences between IFRS and the Company's current accounting policies, as well as assessing the impact of various accounting alternatives offered pursuant to IFRS. In addition, a high level assessment of the Company's information Technology Systems and tax processes will be conducted. The financial impact of the transition to IFRS cannot be reasonably estimated at this time, however, there may be changes in accounting policies and these may impact the Company's financial statements.

In January 2009, the CICA issued the following new Handbook sections:

- i) Section 1582, "Business Combinations", which replaces Section 1581, "Business Combinations". The Section establishes standards for the accounting for a business combination. It provides the Canadian equivalent to the IFRS standard, IFRS 3 (Revised), "Business Combinations". The Section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. Earlier application is permitted. The Company is currently evaluating the impact of the adoption of this new Section on the consolidated financial statements.
- ii) Section 1601, "Consolidated Financial Statements", and Section 1602, "Non-controlling Interests", which together replace Section 1600, "Consolidated Financial Statements", Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of IFRS standard, IAS 27 (Revised), "Consolidated and Separate Financial Statements". The Sections apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier adoption is permitted as of the beginning of a fiscal year. The Company is currently evaluating the impact of the adoption of these new Sections on the consolidated financial statements.

## **Management's Report on Internal Control over Financial Reporting**

Pursuant to Regulation 52-109 *respecting certification of disclosure in issuers' annual and interim filings* ("Regulation 52-109"), the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") of the Company will file an alternative form of certificate for the first period following a reverse take-over since the Company became a reporting issuer. This certificate is filed with respect to the financial information contained in the unaudited interim financial statements and respective accompanying Management's Discussion and Analysis for the period ended June 30, 2009.

In contrast to the full certificate under Regulation 52-109, the alternative form includes a "Note to Reader" stating that the CEO and CFO do not make any representations relating to the establishment and maintenance of disclosure controls and procedures and internal control over financial reporting, as defined in Regulation 52-109.

## **Risks and Uncertainties**

The Company's ability to generate revenue and profit from operations is subject to a number of risks. The risks and uncertainties described below are not the only ones Xebec faces. Additional risks and uncertainties, including those that the Company is not aware of now or that management may believe are currently not material, may also adversely affect the ability to generate a viable business. The risk factors presented below are divided into categories of risks impacting Xebec's internal and external environment. Specific risks within each category are listed in approximate order of seriousness, from most to least serious.

### **Xebec has a limited operating history and it may be difficult to assess its business and future prospects**

Xebec commenced operations in June 2007 following the management buy-out of the assets and business of Xebec Inc., and since that time, Xebec has been engaged in the development, manufacture, and supply of compressed air and gas products. For the year ended December 31, 2008, Xebec's sales totaled approximately \$16.8 million. Xebec's historical operating data may be of limited value in evaluating Xebec's future prospects.

### **Potential fluctuations in financial results make financial forecasting difficult**

Xebec expects its revenues, expenses, cash flows, and other operating results to vary significantly from quarter-to-quarter. Sales and margins may be lower than anticipated due to general economic conditions and market-related factors, product quality, performance and safety issues, and competitive factors. Expenditures and cash receipts may also vary due to the timing of such expenditures and cash collections from customers, government entities, and other entities providing funding to Xebec. As a result, comparisons of revenues, expenses, cash flows, and other operating results may not be meaningful.

### **Xebec depends upon a limited number of customers for potential revenue due to the nature of its markets**

To date, a small number of customers have accounted for a majority of Xebec's revenues and Xebec expects that they will continue to do so for the foreseeable future. For the six-month period ended June 30, 2009, sales to two principal customers accounted for approximately 47% of Xebec's total revenue. For the year ended December 31, 2008, sales to two principal customers accounted for approximately 32% of Xebec's total revenue.

### **Xebec sells its products to a limited number of customers, some of which may experience financial difficulty, which may result in bad debt for Xebec**

The current financial crisis can be expected to affect the ability of some of Xebec's customers to pay their invoices in a timely fashion. Xebec sells to customers of varying financial strengths in various geographic locations. Some of these customers, particularly smaller companies with limited financial resources, may be unable to pay their invoices when they become due. This risk is amplified by the current liquidity crisis and general decline in global economies which is calling into question the sustainability of some of Xebec's customers. Xebec mitigates this risk through

its standard contract terms for significant equipment sales, which require payment of the majority of the contract value prior to shipment. Nevertheless, it is possible that some of Xebec's customers will default on certain amounts owing. Account receivable insurance provided by Export Development Canada and Sinasure in China may only partially protect Xebec from potential losses resulting from such commercial risks if customers refuse to pay or are in default.

**Xebec anticipates undergoing a period of continuing growth in its business, the scope of its operations and the number of its employees, and its failure to manage this growth could cause its results to fluctuate and harm its business**

Xebec anticipates undergoing a period of growth in the scope of its operations and in the number of its employees. Xebec may be unable to manage its growth effectively, and its failure to do so could have a material adverse effect on its operating results and cause its results to fluctuate. As part of its growth strategy Xebec may introduce new products, increase its outsourcing capacity and develop additional customer and distributor relationships. Expansion will likely place a strain on its senior management team, key and technical personnel, its business operations and other resources. Xebec's ability to manage growth will depend in part on its ability to continue to enhance its manufacturing and management information systems. It may be difficult to increase manufacturing or outsourcing capacity in a timely fashion if customer demands increase in ways that Xebec did not anticipate. Any inability to manage growth could result in shipment delays and cancellation of customer orders.

**Xebec may be unable to pursue its long term development and commercialization plans and may have to forego attractive business opportunities**

Xebec may require additional capital to fund its operations and to acquire or invest in complementary businesses or products or obtain the right to use complementary technologies. Xebec may be unable to raise additional capital or may not be able to do so on acceptable terms to pursue its long-term development and commercialization plans. Either of these outcomes could adversely affect the ability of Xebec to respond to competitive pressures or prevent Xebec from conducting all or a portion of its planned operations. The development and commercialization of its products could be delayed or discontinued if Xebec is unable to fund its research and product development activities or the continued development of its manufacturing capabilities. In addition, it may be forced to reduce its sales and marketing efforts or forego attractive business opportunities.

**Xebec's strategy for the sale of its products depends upon developing key relationships with a number of customers who will incorporate its products and technologies into theirs**

Other than with respect to a limited number of specific markets, the success of Xebec's business depends on its ability to develop relationships with parties who will integrate Xebec's products and technologies into their products. The ability of Xebec to sell its products and technologies to its target markets depends to a significant extent upon its partners' worldwide sales and distribution network and service capabilities.

**Xebec has foreign currency risk**

The majority of Xebec's revenues are in U.S. dollars and Euros, while a significant portion of the operating expenses are in Canadian dollars and Chinese Yuan. Foreign exchange gains and losses are included in results from operations. A large decline in the U.S. dollar, the Euro or Chinese Yuan relative to the Canadian dollar could impair revenues, margins, and other financial results. Xebec has not entered into foreign exchange contracts to hedge against gains and losses from foreign currency fluctuations.

**Xebec will need to recruit, train and retain key management and other qualified personnel to successfully expand its business**

Xebec's future success will depend in large part upon its ability to recruit and retain experienced research and development, engineering, manufacturing, operating, sales and marketing, customer service, and management personnel. If Xebec does not attract and retain such personnel, it may not be able to expand its business. Competition for qualified personnel in its industry is intense. Even if Xebec invests significant resources to recruit, train, and retain qualified

personnel, Xebec may not be successful in its efforts. Xebec's success also depends upon the continuing contribution of its key management, research, product development, engineering, marketing, and manufacturing personnel, many of whom would be difficult to replace.

**Xebec currently faces and will continue to face significant competition from other developers and manufacturers of air and gas purification systems**

Xebec competes with a number of companies that manufacture conventional air and gas purification equipment and other competing technologies. New developments in technology may adversely affect the development or sale of some or all of Xebec's products and technologies, or make its products and technologies uncompetitive or obsolete. Other companies, many of which have substantially greater resources than Xebec does, are currently engaged in the development of products and technologies that are similar to, and competitive with, many of its products and technologies. Xebec's competition includes numerous companies located throughout the world, some of which may have advantages over Xebec in terms of government incentives, labour, component costs and technology. Each of these competitors has the potential to capture market share in Xebec's target markets, which could harm its position in the industry. New competitors may also emerge and entire product lines may be threatened by new technologies or market trends which reduce the commercial viability of Xebec's product lines. In addition, Xebec's customers could potentially become its competitors if they decide to develop and manufacture their own gas purification systems. As the markets for air and gas purification systems develop, other large industrial companies may enter these fields and compete with Xebec. These large industrial companies may have research and development, manufacturing, marketing and sales resources necessary to deliver air and gas purification systems more quickly and effectively than Xebec does. Xebec may not be able to compete effectively with all of these competitors, which could adversely affect its business, financial condition and results of operations.

**Protection of Technology and Development**

There can be no assurances that Xebec will meet its targeted development or integration timelines, secure components at reasonable prices such that it will be able to offer its products and technologies at competitive pricing, or that Xebec can continue to enhance and improve the functionality and features of its technologies. In addition, Xebec depends on its ability to develop and maintain proprietary aspects of its technology, if and when required. Xebec's products incorporate complex technology and software. Accordingly, they may contain errors that could be detected at any point. Such errors could materially and adversely affect Xebec's reputation, or that of its customers and partners, resulting in claims and/or significant costs to Xebec, and/or cause customers and other parties to abandon Xebec and impair its ability to market and sell its products in the future.

**Xebec is dependent upon third party suppliers for materials and components for its products**

Xebec relies upon third party suppliers to provide materials and components for its products. A supplier's failure to provide materials or components in a timely manner, or to provide materials and components that meet Xebec's quality, quantity or cost requirements, or its inability to obtain substitute materials and components in a timely manner or on terms acceptable to Xebec, may harm Xebec's ability to manufacture its products. To the extent that Xebec is unable to develop and patent its own technology and manufacturing processes, and to the extent that the processes, which its suppliers use to manufacture materials and components, are proprietary, Xebec may be unable to obtain comparable materials or components from alternative suppliers, and that could adversely affect its ability to produce commercially viable products.

**Xebec is subject to a variety of governmental regulations**

Xebec is subject to a variety of federal, provincial, state, local and international laws and regulations relating namely to the environment, health and safety, export controls, currency exchange, labour and employment and taxation, namely in Canada, China and Singapore. These laws and regulations are complex, change frequently and have tended to become more stringent over time. Failure to comply with these laws and regulations may result in a variety of administrative, civil and criminal enforcement measures, including assessment of monetary

penalties, imposition of remedial requirements and issuance of injunctions as to future compliance. From time to time, as part of Xebec's operations, including newly acquired operations, Xebec may be subject to compliance audits by regulatory authorities in the various countries in which it operates.

**Risk factors related to Xebec's target markets Xebec's markets are exposed to recessionary risk**

The current financial crisis and possible global recession may result in lost or delayed sales orders, as many of Xebec's existing and targeted customers may cut back their proposed capital spending in the face of economic uncertainty and limited access to project financing. This would impact the ability of Xebec to grow its business, and as a result sales orders may be lower than expected. Any decrease in sales would negatively impact Xebec's cash flows and other financial results. Different air and gas purification markets and different geographies may be impacted to different extents, making it difficult to forecast the likely impact.

**Volatility of oil and natural gas prices**

Xebec's systems represent a significant potential capital cost to Xebec's existing and target customers and their ability to purchase Xebec's products is dependent upon factors which affect energy industries Xebec's existing and target customers' results of operations and financial condition are dependent on the prices they receive for oil, natural gas and renewable natural gas. Oil and natural gas prices have fluctuated widely during recent years and are determined by local and worldwide supply and demand factors, including actions by the Organization of Petroleum Exporting Countries, weather conditions, the U.S. dollar exchange rate, transportation, competition, and general economic conditions as well as conditions in other oil producing regions, which are beyond Xebec's control. Any material decline in oil or natural gas prices could have a material adverse effect on Xebec's existing and target customers' operations, financial condition, and the amount they spend on new capital equipment and the development of new technology, which could have a material adverse effect on Xebec's existing and target customers' ability to purchase Xebec's products. In addition, Xebec's prospects would be adversely affected should the cost of natural gas fall to levels where production of natural gas becomes uneconomic.

**Risks with conducting business in international markets**

Xebec conducts business in many geographic markets outside Canada. Changes in local economic or political conditions, namely in China, could have a material adverse effect on Xebec's business, financial condition, results of operations and cash flows. Additional risks inherent in Xebec's international business activities include the following:

- difficulties in managing international operations, including Xebec's ability to timely and cost effectively execute projects;
- unexpected changes in regulatory requirements;
- training and retaining qualified personnel in international markets;
- inconsistent product regulation or sudden policy changes by foreign agencies or governments;
- the burden of complying with multiple and potentially conflicting laws; tariffs and other trade barriers that may restrict Xebec's ability to enter new markets;
- governmental actions that result in the deprivation of contract rights, including possible law changes, and other difficulties in enforcing contractual obligations;
- foreign currency exchange rate risks;
- difficulty in collecting international accounts receivable;
- potentially longer receipt of payment cycles;
- changes in political and economic conditions in the countries in which Xebec conducts business, including the nationalization of energy related assets, civil uprisings, riots, kidnappings and terrorist acts;
- potentially adverse tax consequences or tax law changes;

- restrictions on repatriation of earnings or expropriation of property without fair compensation;
- the geographic, time zone, language and cultural differences among personnel in different areas of the world; and
- difficulties in establishing new international offices and risks inherent in establishing new relationships in foreign countries. In addition, Xebec may expand its business into international markets where Xebec has not previously conducted business. The risks inherent in establishing new business ventures, especially in international markets where local customs, laws and business procedures present special challenges, may affect Xebec's ability to be successful in these ventures or avoid losses that could have a material adverse effect on Xebec's business, financial condition, results of operations and cash flows.

#### **Specific risks with Xebec's sales to Iran**

Our business relationships in Iran are subject to numerous risks and uncertainties associated with doing business in Iran. These risks include, among other things, political, social and economic instability, civil uprisings, riots, terrorism, kidnapping, the taking of property without fair compensation and governmental actions that may restrict payments or the movement of funds or result in the deprivation of contract rights. Any of these risks, including the possibility of military intervention, could adversely impact Xebec's business relationships in Iran and could affect the timing and decrease the amount of revenue Xebec may realize, directly or indirectly, from its business relationships in Iran. Iran is subject to Canadian export control and economic sanction legislation. Such legislation may also give rise to certain risks and uncertainties for Xebec in the context of its business and operations. If Xebec is unable to continue to generate revenue from its Iranian customers, it may be required to find alternative sources of revenue, which could potentially adversely impact Xebec's financial condition or results of operations.

#### **Insurance**

Xebec's operations are subject to risks inherent in the compressed air and gas purification sectors. Xebec subscribes for insurance in amounts which it considers appropriate in the circumstances and having regard to industry norms. Xebec may become liable with respect to risks in respect of which it cannot obtain insurance or for which it chooses not to obtain insurance as a result of high premiums or for other reasons, or for damages which exceed the maximum coverage provided for in the insurance policies.

#### **Environmental Risks**

All phases of the oil and natural gas business, and of the processing of organic wastes, are subject to environmental regulation pursuant to a variety of Canadian federal, provincial, state and municipal laws and regulations, as well as international conventions (collectively, "Environmental Legislation").

Environmental Legislation imposes, among other things, restrictions, liabilities, and obligations in connection with the generation, handling, storage, transportation, treatment, and disposal of hazardous substances and waste, and in connection with spills, releases, and emissions of various substances to the environment. Environmental Legislation also requires that wells, facility sites, and other properties associated with oil and natural gas operations be operated, maintained, abandoned, and reclaimed to the satisfaction of applicable regulatory authorities. In addition, certain types of operations, including exploration and development projects and significant changes to certain existing projects, may require the submission and approval of environmental impact assessments. Compliance with Environmental Legislation can require significant expenditures and failure to comply with Environmental Legislation may result in the imposition of fines, penalties and liability for clean up costs and damages. Changes in Environmental Legislation due to, namely, climate change concerns, may require, among other things, reductions in emissions to the air from Xebec's existing and target customers' operations and result in increased capital expenditures. Future changes in Environmental Legislation could occur and result in stricter standards and enforcement, larger fines and liability, and increased

capital expenditures and operating costs, which could have a material adverse effect on Xebec's existing and target customers' ability to purchase Xebec's products.

***Foreign Subsidiaries and Affiliates***

Xebec conducts some operations through foreign subsidiaries and affiliates, and significant assets are held in such entities. Accordingly any limitation on the transfer of cash or other assets between the parent corporation and such entities, or among such entities, could restrict Xebec's ability to fund its operations efficiently. Any such limitations, or the perception that such limitations may exist in the future, could have an adverse impact upon the Xebec's valuation and stock price.

***Xebec's directors and officers may have conflicts of interest***

Certain of the directors and officers of Xebec also serve as directors and/or officers of other companies involved in the air and gas compression industry and/or in the renewable energy industry and consequently there exists the possibility for such directors and officers to be in a position of conflict.