



**Xebec Adsorption Inc.**

**Management Discussion and Analysis  
For the three and six-month periods ended June 30, 2011**

**August 11, 2011**

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

## **ABOUT THIS MANAGEMENT DISCUSSION AND ANALYSIS**

The following Management's Discussion and Analysis ("MD&A") provides a review of the results of operations, financial condition and cash flows of Xebec for three and six-month periods ended June 30, 2011, and should be read in conjunction with our audited consolidated financial statements, accompanying notes and MD&A for the year ended December 31, 2010, as well as our unaudited interim condensed consolidated financial statements and accompanying notes for the period ended June 30, 2011. Additional information, including our annual information form (AIF), can be found on SEDAR at [www.sedar.com](http://www.sedar.com).

The financial information presented herein has been prepared on the basis of International Financial Reporting Standards (IFRS) for interim financial statements and is expressed in Canadian dollars unless otherwise stated.

The unaudited IFRS-related disclosures and values in this MD&A have been prepared using the standards and interpretations currently issued and expected to be effective at the end of our first annual IFRS reporting period, which will be December 31, 2011. The amounts in this MD&A and the accompanying interim financial statements for the three and six-month period ended June 30, 2010 have been restated to reflect our adoption of IFRS, effective from January 1, 2010. Periods prior to January 1, 2010 have not been restated and are prepared in accordance with Canadian GAAP. Please refer to Note 4 of the accompanying interim consolidated financial statements for a summary of the differences between our consolidated financial statements previously prepared under Canadian GAAP and those under IFRS for the three and six-month period ended June 30, 2010 and for the year ended December 31, 2010.

The information contained in this MD&A and certain other sections of this report also includes some figures that are not performance measures consistent with IFRS, such as earnings (loss) before amortization, financial expenses, other items and income taxes ("EBITDA"). The Company uses EBITDA because this measure enables management to assess the Company's operational performance. This measure is a widely accepted financial indicator of a company's ability to repay and assume its debt. Investors should not regard it as an alternative to operating revenues or cash flows, or a measure of liquidity. As this measure is not established in accordance with GAAP, it might not be comparable to those of other companies.

The information contained in this Management's Report accounts for any major event occurring up to August 11, 2011, the date on which the Board of Directors approved the unaudited consolidated financial statements and Management's Report for the second quarter of 2011. It presents the Company's status and business context as they were, to management's best knowledge, at the time this report was written.

## **FORWARD-LOOKING STATEMENTS**

This Management Discussion and Analysis ("MD&A") contains forward-looking statements, including statements regarding the future success of the Company's business, technology, and market opportunities. Forward-looking statements typically contain words such as "believes", "expects", "anticipates", "continues", "could", "indicates", "plans", "will", "intends", "may", "projects", "schedules", "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) actions expected to be undertaken to achieve the Company's strategic goals; (ii) the key market drivers impacting the Company's success; (iii) intentions with respect to future biogas development work; (iv) expectations regarding business activities and orders that may be received in fiscal 2011 and beyond; (v) trends in, and the development of, the Company's target markets; (vi) the Company's market opportunities; (vii) the benefits of the Company's products, (viii) the intention to enter into

agreements with partners; (ix) future outsourcing; (x) expectations regarding competitors; (xi) the expected impact of the described risks and uncertainties; (xii) intentions with respect to the payment of dividends; (xiii) the management of the Company's liquidity risks in light of the prevailing economic conditions; (xiv) the Company's cost reduction plan; and (xv) the search for additional financing over the next months. These statements are neither promises nor guarantees, but involve known and unknown risks and uncertainties that may cause the Company's actual results, level of activity or performance to be materially different from any future results, levels of activity or performance expressed in or implied by these forward-looking statements. These risks include, generally, risks related to revenue growth, operating results, industry and products, technology, competition, the economy and other factors described in detail in Xebec's Annual Information Form for the quarter ended June 30, 2011 under the heading "Risk Factors" which is available on SEDAR at [www.sedar.com](http://www.sedar.com) and on Xebec's website at [www.xebecinc.com](http://www.xebecinc.com).

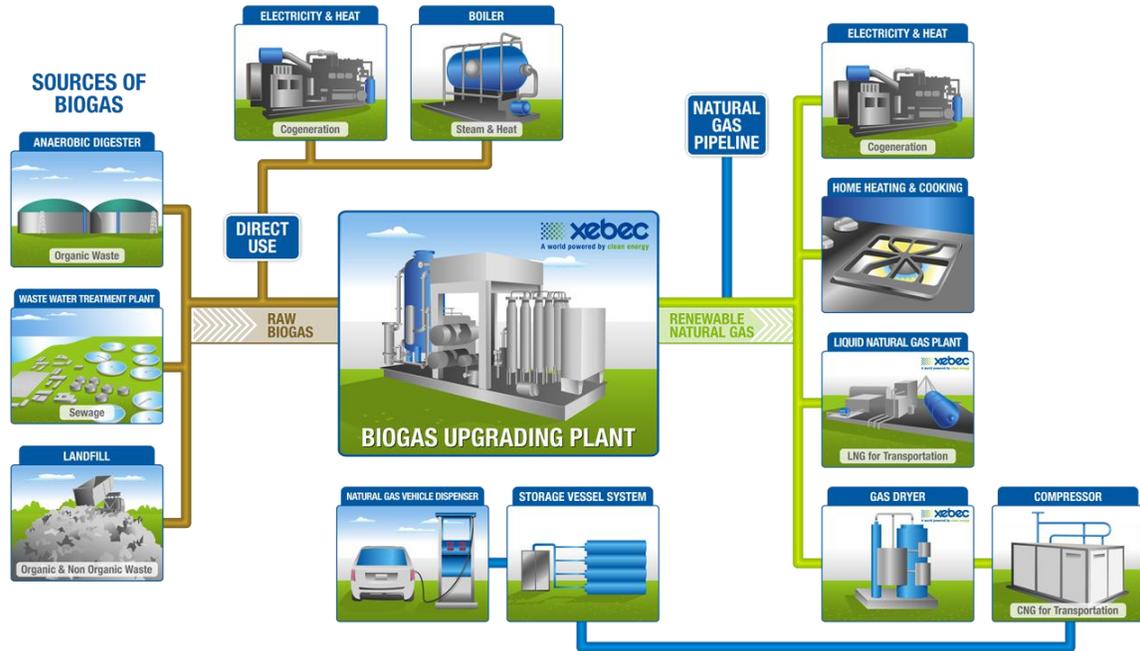
Although the forward-looking statements contained herein are based upon what management believes to be current and reasonable assumptions, the Company cannot assure readers that actual results will be consistent with these forward-looking statements. Examples of such assumptions include, but are not limited to: (i) trends in certain market segments and the economic climate generally; (ii) the pace and outcome of technological development; (iii) the identity and expected actions of competitors and customers; and (iv) the value of the Canadian dollar. The forward-looking statements 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 forward-looking statements contained herein.

## **DESCRIPTION OF THE BUSINESS**

### **CORPORATE OVERVIEW**

Xebec Adsorption Inc. ("Xebec" or "the Company") is a Canadian global provider specialized in the design, engineering and manufacturing of innovative gas solutions and services in the process of transforming raw gases into marketable sources of clean energy. As such, Xebec's strategy is focused on establishing leadership positions in 3 key market and business segments where demand for biogas upgrading, natural gas purification and hydrogen purification is growing. Headquartered in Montreal (QC), Xebec also operates two manufacturing facilities in Montreal and Shanghai, R&D facilities in Vancouver (BC) as well as a sales and distribution network in North America, and Asia. Xebec ([www.xebecinc.com](http://www.xebecinc.com)) trades on the Toronto Stock Exchange ("TSX") under the symbol XBC.

Xebec's products and services are an essential part of a growing industry of transforming raw gases into marketable sources of clean energy:



Xebec's head office is in Blainville, Quebec in a 41,753 square foot manufacturing facility in which 44 people are currently employed. The Blainville operation houses corporate finance, sales for natural gas and biogas purification products, aftermarket support, global supply chain, operational engineering, manufacturing of gas separation and purification equipment and service and maintenance support.

Xebec's 21,868 square foot technology center is located in Burnaby, British Columbia. Xebec also maintains a test laboratory in a 4,137 square foot facility located in Surrey, British Columbia. These facilities primary focus is research and development in adsorption technology and third party contract research and at the end of the quarter employed 15 people comprised of scientists, engineers, technicians and administrative staff. In addition this location houses sales support, project management and service support for Canadian and United States of America west coast customers.

Xebec's Asian 20,451 square foot manufacturing facility is located in the Songjiang district of Shanghai, China. This new facility employs 29 people and is responsible for product engineering and assembly using components manufactured in the greater Shanghai industrial area. The facility also provides shared services including supply chain and engineering support to Xebec's head office. Xebec China is also responsible for sales of Xebec's products, marketing, technical and after-sales support for the Asian and South East Asian markets.

Xebec opened in the first quarter of 2009 along with Angstrom a regional sales office in Singapore. Xebec Singapore is responsible for sales of Xebec's products, marketing, technical and after-sales support for primarily the South East Asian markets. Xebec Singapore currently employs 4 people.

## MARKETS

Xebec mainly targets 3 key market and business segments focused on gaseous fuels used for transportation:

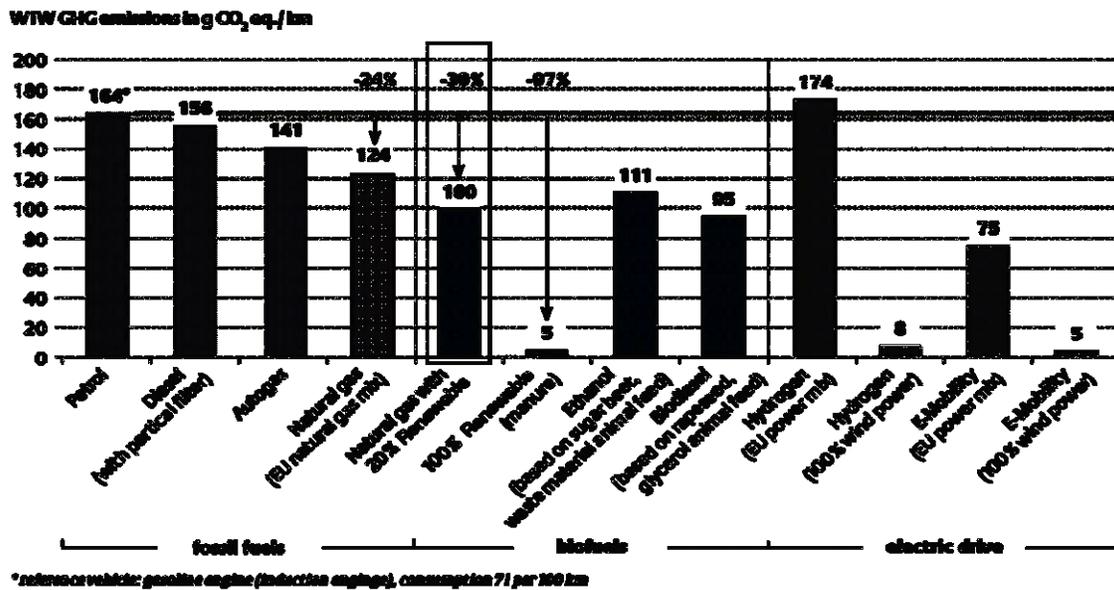
- 1- Biogas upgrading plants
- 2- Natural gas dehydration for NGV refueling stations

### 3- Hydrogen pressure swing adsorption (“PSA”) for hydrogen recovery

Xebec’s current strategy is based on a number of key market drivers and global macro trends driving the demand for Natural Gas and Renewable Gas as a cleaner energy source of a low carbon transportation fuel, amongst them are:

- The abundance and low cost of Natural Gas;
- The rising price of oil and need for greater energy independence and security;
- Climate Changes and the urgent need to reduce greenhouse gas emission (GHG);
- The growing government commitments to renewable energy; and
- Technological advancements

These market drivers are anticipated to fuel demand for renewable gas. GHG reduction targets make renewable gas a good solution for a lower carbon economy in transportation, therefore creating new business opportunities for Xebec.



### COMPETITION

Xebec faces competition within its target markets primarily from other manufacturers of biogas purification, natural gas and hydrogen purification equipment. The natural gas and biogas purification and separation market has not yet seen considerable consolidation, unlike other industrial or renewable industries. Most competitors of Xebec today are small to medium companies working in niche segments of the natural gas and biogas business.

**BGX Solutions:** In the emerging biogas purification market, Xebec expects to compete with manufacturers of competing technologies including membrane separation, amine and water wash systems, as well as advanced and conventional adsorption based systems for the purification of biogas. These competitors include, Acron Technologies Inc., Cirmac International BV, Lackeby Water Group (PURAC), Guild Associates Inc, MT-Biomethan GMBH, Carbotech AC GmbH, Haase Energietechnik AG, Ros Roca Group, Flotech/Greenlane, Yit Vatten Och Misjoteknik, Air Liquide, MalmBerg Water AB and A.R.C. Technologies Corp.

**NGX Solutions:** In the natural gas dryer market Xebec competes with a number of companies who manufacture gas dryers. These companies include SPX Corp., Parker Hannifin Corporation,

Aircel Corp., PSB Industries Inc., Xi'An Unionfilter Purification Equipment Co. Ltd., Zander Aufbereitungstechnik GmbH and Tecno Project Industriale s.r.l.

H2X Solutions: In the hydrogen purification market, Xebec's competition includes Air Liquide, HydroChem, Linde and Air Products.

## **STRATEGY AND OBJECTIVES**

Xebec seeks to become a leader in the development, manufacture and supply of integrated biogas upgrading plants to either pipeline or vehicle-fuel grade renewable natural gas. Biogas is a methane-containing renewable energy source created primarily by the decomposition of organic waste.

Xebec's continues to manage its cost structure and working capital, while increasing its revenue. Xebec intends to actively pursue and implement the following measures:

1. Standardize product offering with strong focus on smaller to medium gas flows, where Xebec's solutions offer inherent size and cost benefits;
2. Xebec is working on monetizing some of its intellectual property and thereby creating additional liquidity through license revenues;
3. Enforce and implement tight cost control measures on all general and administrative costs;
4. Maintain regional sales, service and support infrastructure for Xebec's key markets to strengthen Xebec's sales abilities and support products and systems in the market place;
5. Execution and operational excellence, allowing Xebec to deliver products and solutions at the best price, on time and on budget while meeting or exceeding targeted gross margins;
6. Leverage key relationships with leading channel partners and project developers to penetrate target markets;
7. Continue to proactively address and manage its liquidity and working capital requirements. Xebec's delivery cycle for biogas plants can be 8 to 12 months. The management and funding of working capital is important for the success of the Company.

## **RECENT DEVELOPMENTS**

On July 21, 2011, Xebec has accepted an offer to purchase its building in Blainville. The closing shall occur on or about September 30, 2011. This transaction will be accounted for as a sale and leaseback transaction; the purchaser is leasing back the Blainville location to Xebec for fifteen years.

On July 1, 2011, The Company acquired an additional 16 percent of the outstanding shares of Xebec Adsorption South East Asia PTE. Ltd. The Company converted into equity part of its loan that it had previously made to the joint venture. The Company acquired control of the joint venture.

On March 17, 2011, Xebec announced the execution of a license and engineering agreement for a total value of USD 3.25 million with Nuvera Fuel Cells to allow for the development of two rapid cycle hydrogen purification units for use in hydrogen refueling and merchant hydrogen applications.

On February 8, 2011, Xebec announced the launch of the first renewable energy project in California to purify biogas from a wastewater treatment facility as a joint project between the City of Escondido, Southern California Gas Co. and Xebec.

On January 24, 2011, Xebec announced the extension of engineering services valued at USD 2.0 million to ExxonMobil Research and Engineering Company ("EMRE") for ongoing development work related to new applications for Xebec's proprietary Rapid Cycle PSA technology.

On January 19, 2011, Xebec announced the signature of a contract valued at RMB 6.0 million to provide a complete biogas upgrading plant to Heilongjiang Loonggas Investment Co., Ltd. in China.

## CURRENT BACKLOG

The order backlog is calculated considering contracts received and considered as firm orders.

### Current backlog as of:

Product line:	August 11, 2011	June 13, 2011	November 11, 2010	August 10, 2010
In millions of \$				
Natural Gas Dryers	1,5	2,2	2,1	2,1
Gas Purification	6,8	5,1	8,3	9,2
Others	3,1	3,3	0,4	0,4
<b>Consolidated Backlog</b>	<b>11,4</b>	<b>10,6</b>	<b>10,8</b>	<b>11,7</b>

Major projects included in the current backlog:

#### North America:

Name	Type	Location	Commissioning
Fortis BC	Biogas upgrading plant	British Columbia, Canada	H2-2011
Industrial gas processing	Modular hydrogen plant	USA	H2-2011

#### Asia

Name	Type	Location	Commissioning
Halla Energy	Biogas upgrading plant	South Korea	H2-2011
PT Indo Raya Kimia	PSA System	Indonesia	H2-2011
Heilongjiang Loonggas	Biogas upgrading plant	China	H1-2012
EnergyPot*	Biogas upgrading plant	China	H1-2012

\* On June 17, A Letter of intent was signed with EnergyPot and the final contract is expected to be signed before the end of August.

## OVERALL PERFORMANCE

On June 12, 2009, Xebec completed a reverse takeover of QuestAir Technologies Inc. ("QuestAir") and became listed on the TSX. This transaction was undertaken to bring together complementary gas purification technologies, global distribution networks in high growth markets in North America and Asia, and low-cost opportunity manufacturing and supply chain capabilities. The Company intends to leverage all available synergies to expand its market share in clean energies, such as biogas upgrading, natural gas dehydration and hydrogen purification. Further details regarding the transaction may be found in Note 5 to the financial statements for the year ended December 31, 2010.

With the amalgamation, Xebec underwent a significant change in its business model. The Company is transforming itself from a supplier of components for clean-energy systems to a supplier of clean-energy solutions. At the same time, the Company has been shifting its market focus and business model to biogas upgrading plants, which offer greater opportunities and market leading performance metrics. The nature of these changes is such that the lead times for the sales process and the delivery of systems are much longer than previously. In recognition of this, it is a generally accepted industry practice for customers to pay some of the purchase price up-front, before systems are delivered and installed.

Revenues for the three-month period ended June 30, 2011 were \$4.5 million, compared to \$4.1 million for the corresponding period the previous year.

The backlog of orders to translate in sales over the next year reached \$11.4 million order backlog as of August 11, 2011, compared to \$11.7 million as at August 10, 2010.

Gross profit for the three-month period ended June 30, 2011 reached \$0.9 million, compared to \$0.5 million for the corresponding period the previous year.

EBITDA for the three-month period ended June 30, 2011 reached an amount of \$(0.6) million compared to an amount of (\$2.5) million for the corresponding period the previous year.

As a result, the Company incurred a net loss of \$1 million for the second quarter of 2011 compared to a net loss of \$2.8 million for the same period last year.

In the short and medium term, the future for renewable energy remains positive. Green energy initiatives are on the agendas of municipal, provincial and federal governments worldwide. Corporations and consumers are increasingly looking for green energy solutions to protect the environment and reduce their carbon footprint. Management believes that Xebec, with its complementary product lines, strong customer relationships, global footprint and low-cost opportunities in manufacturing and supply chain, is well positioned to respond to this growing demand.

While some of the target markets were soft in the latter part of 2010, there are signs of increased activity across all business segments, especially the interest for renewable energy projects in the U.S., Canada and China.

## SELECTED QUATERLY FINANCIAL INFORMATION

In millions of \$	Three months ended		% of Change	Six months ended		% of Change
	2011	June 30, 2010		2011	June 30, 2010	
Revenues	4.5	4.1	8.8%	8.6	6.1	39.6%
Gross margin (%)	19.7%	13.4%		33.9%	11.0%	
EBITDA	(0.6)	(2.5)		(0.5)	(5.2)	
Net income (loss)	(1.0)	(2.8)	-63.2%	(1.3)	(6.2)	-79.6%
Net income (loss) per share - basic and diluted (\$/share) *	(0.03)	(0.10)		(0.03)	(0.21)	
Total assets (as of December 31,2010)	11.8	15.2		11.8	15.2	
Total long-term financial liabilities (as of December 31,2010)	2.7	2.9		2.7	2.9	

## FINANCIAL HIGHLIGHTS OF THE SECOND QUARTER 2011

- Revenues of \$4.5 million in the second quarter of 2011, a 8.8% increase compared to \$4.1 million in the second quarter of 2010.
- Gross margin (%) increased from 13.4% in the second quarter of 2010 to 19.7% in the second quarter of 2011.
- The EBITDA reached \$(0.6) million in the second quarter of 2011 compared to \$(2.5) million in the second quarter of 2010.
- Net loss of \$1.0 million in the second quarter of 2011 compared to a net loss of \$2.8 million in the second quarter of 2010, a 63.2% decrease.
- Loss per share of \$0.03 in the second quarter of 2011 compared to a loss per share of \$0.10 in the second quarter of 2010.
- Order backlog of \$11.4 million as at August 11, 2011 compared to \$11.7 million as at August 10, 2010.

## RESULTS OF OPERATIONS

### Revenues

In millions of \$	Three months ended		Six months ended	
	2011	June 30, 2010	2011	June 30 2010
North America	3.1	2.1	6.6	3.2
Asia	1.1	0.9	1.4	1.4
Oceany	0.2	-	0.2	-
Europe	0.1	1.1	0.4	1.4
Middle East	-	-	-	0.1
Other	-	-	-	-
<b>Total</b>	<b>4.5</b>	4.1	<b>8.6</b>	6.1

### Product Line

In millions of \$	Three months ended		Six months ended	
	2011	June 30, 2010	2011	June 30 2010
Gas Purification	1.8	0.9	2.9	1.2
Natural Gas Dryers	1.7	2.3	2.1	2.8
Licensing	-	-	1.5	-
Engineering Services	0.5	-	1.1	0.1
Compressed gas filtration	0.5	0.8	0.9	1.8
Air dryers	-	0.1	0.1	0.2
<b>Total</b>	<b>4.5</b>	4.1	<b>8.6</b>	6.1

For the second quarter of 2011, the total revenues amounted to \$8.6 million, compared to \$6.1 million for the same period last year. The total three month revenues amounted to \$4.5 million, compared to \$4.1 million for the second quarter of 2010. The Gas Purification revenues increased as a result of the Company's decision to change the business focus to biogas upgrading solutions. The Natural Gas Dryer revenues decreased due to the Company's decision to cease activities in specific Middle East markets affecting the sales of our China division. The Aftermarket & Field Services revenues decreased but are expected to improve over the next few quarters. The new contract with ExxonMobil Research and Engineering Company increased the engineering services revenues for the six month period. Discussions are currently undergoing with ExxonMobil Research and Engineering Company to amend the contract. The Licensing revenues resulted from the licensing agreement previously mentioned for the development of two rapid cycle hydrogen purification units.

## Gross Profit

In millions of \$	Three months ended June 30,		Six months ended June 30	
	2011	2010	2011	2010
Revenues	4.5	4.1	8.6	6.1
Cost of Goods Sold	3.6	3.6	5.7	5.4
Gross Profit*	0.9	0.5	2.9	0.7
Gross Margin (%)	19.7%	13.4%	33.9%	11.0%

\* Gross Profit is a non-IFRS financial measure.

For the second quarter of 2011, the gross margin amounted to \$0.9 million compared to \$0.5 million for the same period in 2010. The Natural Gas Dryer gross margin decreased compared to 2010 since the Company ceased its activities in specific Middle East markets. The After-market margin have slightly declined compared to 2010 due to the rising costs of materials combined with lower sales, which resulted in lesser absorption of overhead costs. The Air Dryer gross margin decreased compared to 2010 due to the business decision to no longer pursue sales of ADX in North America leaving sales volume only in Asia with a lower gross margin.

The Gas Purification gross margin increased compared to 2010 due to higher volume of PSA systems sold in 2011 compared to 2010 and better cost controls of our Biogas plants.

The Engineering Services gross margin increased compared to 2010 due to newly added engineering contracts.

For the six-month period ended June 30, 2011, the total gross margin amounted to \$2.9 million, compared to \$0.7 million for the same period last year. This is mainly due to newly added engineering and license revenues and for the aforementioned reasons.

## EBITDA

We report on our EBITDA (Income from operations before depreciation and amortization and special charges). EBITDA is not a performance measure defined under IFRS and is not considered an alternative to income from operations or net (loss) earnings in the context of measuring Company's performance. EBITDA does not have a standardized meaning and is therefore not likely to be comparable with similar measures used by other publicly traded companies.

The EBITDA reached \$(0.6) million in the second quarter of 2011 compared to \$(2.5) million for the same period last year. The improvement in the EBITDA is the result of an increase in license revenues, a better gross margin and lower overhead expenses due to a restructuring and the implementation of cost control measures.

For the six-month period ended June 30, 2011, the EBITDA reached \$(0.5) million, compared to \$(5.2) million for the same period last year for the aforementioned reasons.

## Selling and Administrative

Selling and administrative expenses were \$1.8 million in the second quarter of 2011 compared to \$2.7 million for the same period last year. For the six-month period ended June 30, 2011, selling and administrative were \$3.7 million, compared to \$5.4 million for the same period last year. The decrease in expenses is the results of the company's restructuring and the implementation of cost control measures.

**Research and Development**

Research and development expenses, net of research and tax credits were \$34,660 in the second quarter of 2011, compared to \$578,224 for the same period in 2010. For the six-month period ended June 30, 2011, Research and development expenses, net of research and tax credits were \$386,340, compared to \$1,121,116 for the same period last year. The decrease in expenses is also attributable to the cost control measures and the newly added engineering contract that have move R&D employees into a commercial role.

**Financial**

Financial expenses decreased for the three-month period ended June 30, 2011 to \$97,656, from \$170,638 for the same period in 2010. The decrease in the second quarter is the result of lower financing costs and less financial charges related to the ceased activity in the Middle East markets.

Financial expenses decreased for the six-month period ended June 30, 2011 to \$211,101, from \$305,732 for the same period in 2010.

**Foreign Exchange Loss**

In the second quarter of 2011, the Company had a foreign exchange gain of \$19,465, compared to a foreign exchange gain of \$134,541 for the second quarter of 2010. The year-over-year change was primarily due to the impact of a strengthening Canadian dollar on foreign exchange transactions and the extinction of the derivative financial instrument during the second quarter of 2010. The derivative financial instrument was related to a Euro-denominated contract with a foreign counterparty.

For the six-month period ended June 30, 2011, foreign exchange gain was \$127,925, compared to a loss of \$62,913 for the same period last year.

**Net loss**

Net loss for the three-month period ended June 30, 2011 was \$1.0 million, or \$0.03 per share, compared to net loss of \$2.8 million, or \$0.10 per share, for the same period in 2010, reflecting primarily a \$0.4 million increase in gross margins and a \$0.9 million decrease in selling and administrative costs.

For the six-month period ended June 30, 2011, net loss was \$1.3 million or \$0.03 per share, compared to \$6.2 million or \$0.21 per share for the same period in 2010, reflecting primarily a \$2.2 million increase in gross margins and a \$1.7 million decrease in selling and administrative costs.

## SUMMARY OF QUARTERLY RESULTS

In millions of \$ (except per share data)	IFRS		Canadian GAAP		IFRS		Canadian GAAP	
	2011		2010		2010		2009	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Revenues	4.5	4.1	3.4	4.0	4.1	2.0	3.8	5.9
Net income (loss)	(1.0)	(0.2)	(4.4)	(3.1)	(2.8)	(3.4)	(5.0)	(1.2)
Earnings (loss) per share basic and diluted	(0.03)	0.00	- (0.14)	(0.10)	(0.10)	(0.11)	(0.23)	(0.06)

Given the nature and early stage of Xebec's business, there are no apparent seasonal or other discernible trends at this time.

Xebec resulted from the amalgamation with QuestAir on June 12, 2009. The financial results for 2009 include the accounts of QuestAir from June 12, 2009. The first quarter of 2009 is prior the amalgamation with QuestAir. In addition to transaction costs, there have been integration costs and additional operating, compliance and regulatory costs in the second half of the year.

## LIQUIDITY AND CAPITAL RESOURCES

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 millions of \$	Three months ended			Six months ended		
	June 30,			June 30,		
<b>Cash flow from (used in)</b>	<b>2011</b>	2010	Change	<b>2011</b>	2010	Change
Operating activities	(1.1)	(2.7)	1.6	(2.2)	(3.0)	0.8
Investing activities	0.8	(0.1)	0.9	0.5	(0.1)	0.6
Financing activities	-	-	-	-	(0.1)	0.1

Given the change in business model and the early stage of Xebec's biogas upgrading business, the Company needs to strengthen its financial capabilities in order to meet its operating cash needs. Xebec is actively working on monetizing some of its assets and certain part of its intellectual property and thereby creating additional liquidity through the execution of licenses.

### Operating activities

In the second quarter of 2011, the operating activities used \$1.1 million of cash, compared to \$2.7 million for the same period of 2010. For the six-month period ended June 30, 2011, operating activities used \$2.2 million of cash, compared to \$3.0 million of cash generated for the same period last year. The increase in cash flow from operating activities reflects mainly the impact of our cost cutting controls and the reduction of our inventories.

### **Investing activities**

Investing activities generated \$0.8 million of cash in the second quarter of 2011, compared to \$(0.1) million used for the corresponding second quarter of 2010. For the six-month period ended June 30, 2011, investing activities generated \$0.5 million, while in the same corresponding period of 2010 the investing activities used \$(0.1) million. This mostly reflects the result of decrease of the restricted cash held in trust.

### **Financing activities**

The financing activities used \$19,305 of cash for the second quarter, compared \$55,101 for the same period of 2010.

For the six-month period ended June 30, 2011, financing activities used \$48,997 while in the same corresponding period of 2010 the investing activities used \$87,130

### **Financial position**

As of June 30, 2011, the Company had \$0.5 million of cash on hand, \$0.5 million outstanding in short-term bank loans, and \$2.1 million of long-term debt outstanding, of which \$0.3 million is due within one year.

The Company has access to credit facilities in the amount of \$0.5 million which bore interest at the bank's prime rate plus 2.50% per annum and were limited by certain requirements concerning pre-shipment costs.

The Company is currently negotiating Credit Facilities as discussed in the going concern section.

### **GOING CONCERN**

These consolidated financial statements have been prepared on the basis of accounting principles applicable to a going concern, which assume the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. The Company has incurred an operating loss of \$1,031,835 for the three-month and \$1,258,375 for the six-month ended June 30, 2011 (\$13,161,382 for the year ended December 31, 2010) and has a deficit of \$22,023,045 and a negative working capital of \$3,788,706 as at June 30, 2011 (\$20,764,670 and \$2,843,329 as at December 31, 2010). The current financial position indicates that there is doubt about the Company's ability to continue as a going concern.

The Company's ability to continue as a going concern is primarily dependent on its ability to generate sufficient future cash flows to fund its operations and to settle its obligations on a timely basis. On November 2, 2010, management concluded a share offering which provided the Company with gross proceeds of \$3,796,754.

On March 17, 2011, the Company signed a license and engineering service agreement amounting to US\$3,250,000 including an up-front payment of US\$1,750,000. In addition, the Company undertook various initiatives, such as a cost reduction and return to profitability program to manage its operations and liquidity risks in light of prevailing economic conditions. There is no assurance that such efforts will be successful. However, and as a result of this plan, as of June 30, 2011, the net loss for the period is \$1,031,835, compared to a net loss of \$2,806,079 for the corresponding period as at June 30, 2010. Operating activities, before changes in items of working capital, used \$(667,660) as of June 30, 2011 compared to a use of \$(5,470,700) for the corresponding period ended June 30, 2010.

These consolidated financial statements do not reflect the adjustments to the carrying values of assets and liabilities, the reported expenses and the balance sheet classifications that would be

necessary if the Company was unable to continue as a going concern, and these adjustments could be material.

## **OUTSTANDING SHARE DATA**

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 June 30, 2011, Xebec had 39,363,867 common shares issued. A number of 5,834,249 common shares held in escrow were cancelled on May 31<sup>st</sup> 2011 as the performance targets were not achieved, as described in note 17 of the Company's audited consolidated financial statements for the period-ended December 31, 2010.

### ***Share Purchase Warrants Outstanding***

As at June 30, 2011, 10,658,136 Share Purchase Warrants were outstanding. 4,292,700 Share Purchase Warrants entitling the holder to acquire one Common Share per Share Purchase Warrant at a price of \$1.10 expired on May 25, 2011 and 505,588 Share Purchase Warrants entitling the holder to acquire one Common Share at a price of \$0.77 per share expired on May 25, 2011, 10,091,886 Share Purchase Warrants entitling the holder to acquire one Common Share at a price of \$0.45 per share until November 2nd 2015, 566,250 Share Purchase Warrants entitling the holder to acquire one Common Share at a price of \$0.40 per share until May 2<sup>nd</sup> 2012.

The 10,091,886 warrants are subject to an accelerated expiry if, at any time after December 31, 2010, the published closing trade price of the Common Shares on the TSX is equal or superior to \$0.75 for any 20 consecutive trading days, in which event Xebec may give the holder a written notice that the warrants will expire at 5:00 p.m. (Toronto Time) on the 30<sup>th</sup> day from the receipt of such notice.

### ***Stock Options Outstanding***

Upon the reverse takeover, the Company assumed QuestAir's omnibus 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 or 10% of the common shares issued and outstanding. As at June 30, 2011, the maximum number of common shares available for issuance under all stock-based compensation arrangements is 3,637,091.

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 on the TSX 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, 2011, the Company had 269,237 options outstanding under the plan with a weighted average exercise price of \$2.30

## **SUBSEQUENT EVENTS**

On July 21, 2011, Xebec has accepted an offer to purchase its building in Blainville. The closing shall occur on or about September 30, 2011. This transaction will be accounted for as a sale and leaseback transaction; the purchaser is leasing back the Blainville location to Xebec for fifteen years.

On July 1, 2011, The Company acquired an additional 16 percent of the outstanding shares of Xebec Adsorption South East Asia PTE. Ltd. The Company converted into equity part of its loan that it had previously made to the joint venture.

## CONTINGENT BALANCE-SHEET FINANCING ARRANGEMENTS

Prior to the transaction on June 12, 2009, Xebec (previously “QuestAir”) received funding contributions from various programs of the Canadian Government to support the development and commercialization of our gas purification technology. The Company has not entered into any new contingent off-balance sheet financing arrangements since then.

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:

Funding Award Date	Description	Royalties	Term	Royalty Payments to Date
June 6, 2003	Fast Cycle Pressure Swing Adsorption	Annual royalties of 0.471% since October 1, 2009 (1.165% until September 30, 2009) 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: \$963,802 (\$963,802 in December 2010)  Accrued for future payment: \$75,493 (\$63,493 in December 2010)
March 30, 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 (\$56,726 in December 2010)  Accrued for future payment: \$101,370 (\$101,370 in December 2010)

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

In 2005, QuestAir was 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:

Funding Award Date	Description	Royalties	Term	Royalty Payments to Date
--------------------	-------------	-----------	------	--------------------------

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 30, 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 30, 2014, to a maximum cumulative repayment of \$193,944, whichever occurs first.	Total cumulative payments: \$0 Accrued for future payment: \$0

## FINANCIAL AND OTHER INSTRUMENTS

### ***Derivative Financial Instruments***

The Company had engaged in a sales contract with a foreign counterparty for which the contract was denominated in a currency other than the Canadian dollar or the functional currency of the foreign party. As at June 30, 2011, there is no bifurcated embedded derivative (none as at June 30, 2010) and the fair value from prior year 2009 amounting to \$96,645 was included in the foreign exchange gain (loss) on the statement of income (loss) and comprehensive income (loss) in fiscal year 2010.

### ***Currency Risk***

In the second quarter of 2011, the Company realizes approximately 87% of its sales and 44% of its purchases in foreign currency (respectively 86% and 45% for the six-month period ended June 30, 2011). Consequently, some assets and liabilities are exposed to foreign exchange fluctuations. The Company does not use financial instruments to reduce this risk.

Management does not believe that the impact of foreign exchange fluctuations will be significant and, therefore, has not provided a sensitivity analysis of the impact of fluctuations on net loss and comprehensive loss.

### ***Interest Rate Risk***

Interest rate risk is the risk that the fair value or future cash flows of financial instruments will fluctuate as market interest rates change. The Company does not use financial instruments to reduce this risk.

The Company is exposed to interest rate risk on its bank debt, both short-term and long-term, for which the interest rates charged fluctuate based on the bank prime rate. The short-term bank loan as at June 30, 2011 is \$500,000 (2010 - \$496,900) and the long-term debt that is subject to the variability of the interest rate fluctuation is \$1,756,608 (2010 - \$1,987,943).

The annual interest rate is the bank prime rate plus 2.50%. If the interest rate on the bank debt had been 50 basis points higher (lower), related to the bank debt outstanding during the three-month period and the six-month period ended June 30, 2011, net loss would have been respectively \$2,821 and \$5,661 (2010 \$3,106 and \$6,265) higher (lower).

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

In our 2010 annual consolidated financial statements and notes thereto, as well as in our 2010 Annual MD&A, we have identified the accounting policies and estimates that are critical to the understanding of our business operations and our results of operations. On January 1, 2011, with the adoption of IFRS, the critical accounting policies and significant judgments and estimates

have been updated to conform to this adoption. Please refer to Note 3 of the accompanying interim financial statements for details on the IFRS accounting policies adopted under IFRS and a detailed discussion regarding our significant judgments and estimates.

**Recent Accounting Pronouncements**

In February 2008, the Accounting Standards Board (AcSB) confirmed that IFRS will be mandatory in Canada for profit-oriented publicly accountable entities for fiscal periods beginning on or after January 1, 2011. Our first annual IFRS financial statements will be for the year ending December 31, 2011 and will include the comparative period of 2010. Starting with this report, we have provided unaudited condensed consolidated quarterly financial information in accordance with IFRS including comparative figures for 2010. Please refer to Note 4 of the accompanying financial statements for a summary of the differences between our financial statements previously prepared under Canadian GAAP and to those under IFRS as at January 1, 2010, for the three-month period ended June 30, 2010, and for the year ended December 31, 2010.

The policies applied in the condensed interim consolidated financial statements are based on IFRS issued and outstanding as of August 11, 2011, the date the Board of Directors approved the statements. Any subsequent changes to IFRS that are given effect in the Company’s annual consolidated financial statements for the year ending December 31, 2011, could result in restatement of these condensed interim consolidated financial statements, including the transition adjustments recognized on changeover to IFRS.

**IFRS 9 - Financial Instruments**

IFRS 9 is the first phase of the IASB’s three phase project to replace IAS 39 Financial Instruments: Recognition and Measurement. It is applicable to financial assets and requires classification and measurement in either the amortized cost or the fair value category. IFRS 9 is applied prospectively with transitional arrangements depending on the date of application. The Standard is not applicable until annual periods beginning on or after January 1, 2013, but is available for early adoption.

**Related party transactions**

The following table presents a summary of the related party transactions:

	For the three-month period ended		For the six-month period ended	
	June 2011	June 2010	June 2011	June 2010
	\$	\$	\$	\$
Marketing and professional services expenses paid to companies controlled by members of the immediate family of a shareholder	14,583	31,257	14,583	66,085
Sales to the joint venture	21,649	2,554	46,604	3,142
Interest expense paid to the joint venture	433	382	854	759
	<u>36,665</u>	<u>34,193</u>	<u>56,041</u>	<u>69,986</u>

These transactions are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

**DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROL OVER FINANCIAL REPORTING**

**Disclosure Controls and Procedures**

Our management is responsible for establishing and maintaining disclosure controls and procedures (“DC&P”) designed to provide reasonable assurance that the information we are required to disclose in our annual filings, interim filings and other reports (the “reports”) filed or submitted under the applicable securities legislation is recorded, processed, summarized and reported within the time periods specified in the applicable securities legislation. DC&P include, without limitation, controls and procedures designed to ensure that the information required to be disclosed by an issuer in the reports filed or submitted under the applicable securities legislation is accumulated and communicated to the issuer’s management, including its Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

As at June 30, 2011, an evaluation was carried out, under the supervision of and with the participation of our management, including the President and Chief Executive Officer and the Chief Financial Officer, of the design and effectiveness of our disclosure controls and procedures as defined under NI 52-109. This evaluation was based on the framework set forth in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Upon such review, the Chief Executive Officer and the Chief Financial Officer determined that there were material weaknesses in the design of our DC&P. However, the DC&P deficiencies we identified did not result in adjustments to our interim consolidated financial statements for the third quarters of 2011 and 2010. We have identified the following material weaknesses:

#### ***Entity Level Controls***

We did not maintain a completely effective control environment as defined in accordance with COSO control framework. Specifically, we do not have comprehensive procedure manuals to clearly communicate management’s and employees’ roles and responsibilities in our internal control over financial reporting. To mitigate the risk, management relies heavily on manual procedures and detection controls, management meetings, quarterly reviews of financial statements by our subsidiaries and by the Audit Committee. These manual procedures were performed during the interim periods ended June 30, 2011 and 2010.

#### ***Internal Control over Financial Reporting***

Our internal control over financial reporting (“ICFR”) includes, among others, those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with IFRS, and that our receipts and expenditures are being made only in accordance with authorization of our management; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

We carried out an evaluation of our ICFR, under the supervision of and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer as to the material weaknesses relating to the design of our ICFR as of June 30, 2011. This evaluation was based on the Internal Control-Integrated Framework issued by the COSO. The evaluation considered the procedures designed to ensure that information required to be disclosed by the Company in reports filed or submitted under the applicable securities legislation is recorded, processed, summarized and reported in the time periods specified in the rules and forms of the applicable securities legislation and communicated to our management as appropriate to allow discussions regarding required disclosure. Upon such review, our Chief Executive Officer and Chief Financial Officer have determined that there existed material weaknesses in the design of our ICFR. The ICFR weaknesses we identified did not result in adjustments to our interim consolidated financial statements for the third quarters of 2011 and 2010. Following our assessment, we identified the following material weaknesses:

### *Information Technology General Controls*

We did not adequately maintain effective control over access to our accounting system within our accounting department. In addition, the backup tapes were not periodically tested to ensure their accuracy and there is no information technology strategic plan and no business continuity plan. There is also no periodic review performed on the security logs for failed logins. We are actually in the process of implementing controls over program development and program changes.

The potential ability for someone to improperly access and change accounting records is mitigated by the fact that management relies heavily on manual procedures and detection controls, and quarterly reviews of financial statements by management and by the Audit Committee.

### *Segregation of Duties*

We have deficient controls within our accounting department over segregation of duties inherent to the department's size. Specifically, as a result of the limited number of personnel in the accounting department, certain financial personnel had incompatible duties that allowed for the creation, review and processing of certain financial data without independent review and authorization. To mitigate the risk, our management relies heavily on manual procedures and detection controls, regular management meetings, as well as reviews of our financial statements by subsidiaries and by the Audit Committee. These manual procedures were performed for the periods ended June 30, 2011 and 2010.

### ***Remediation of Material Weaknesses in Internal Control over Financial Reporting and Disclosure Controls***

We have initiated the following actions to address the material weaknesses in our DC&P and ICFR identified as of June 30, 2011.

### *Entity Level Controls*

Our Management has taken an active role in responding to the deficiencies identified, including overseeing management's implementation of the remedial measures described below.

### *Information Technology General Controls*

We will implement enhanced information technology policies and procedures specifically with regard to inventory controls and to the system's change management, program development, access over end-of-period process spreadsheets, IT operations and related monitoring. We will implement new procedures that will overcome the accounting system inventory controls and access deficiencies. We will also develop and implement a global information technology strategic plan and a business continuity plan.

### *Inadequate Segregation of Duties*

We will continue to use appropriate measures to restrict or independently monitor systems access and properly assign job roles and responsibilities to employees to ensure the proper segregation of duties where feasible. As the Company grows, we will expand the number of individuals involved in the accounting function.

We realize that some of the above weaknesses are inherent to a company of our size. Nevertheless, we believe in and are committed to establishing rigorous DC&P and ICFR. It will take time to put in place the rigorous controls and procedures desired by our management and Board of Directors. We cannot at this time estimate how long it will take to complete the steps identified above. Our management will continue to evaluate the effectiveness of our overall

control environment and will continue to refine existing controls as they, in conjunction with our Audit Committee, Chief Executive Officer and Chief Financial Officer, think necessary. Again, the control deficiencies which we identified did not result in adjustments to our interim consolidated financial statements for the third quarter of 2011 or any previous periods.

Other than the remediation efforts discussed above and the implementation of the Company's ICFR, there have been no changes in our ICFR that occurred since the beginning of the interim period ended June 30, 2011 that have materially affected or are reasonably likely to materially affect our ICFR. Our management, including our Chief Executive Officer and our Chief Financial Officer, has discussed these issues and remediation efforts with our Audit Committee.

We will provide updates on the remediation plan in our quarterly and annual management's reports.

It should be noted that while our management believes that current disclosure and internal controls and procedures provide a reasonable level of assurance, it cannot be expected that existing disclosure controls and procedures or internal financial controls will prevent all human errors and circumvention or overriding of the controls and procedures. A control system, no matter how well conceived or operated, can provide only reasonable assurance, not absolute, that the objectives of the control system are met.

## **RISKS AND UNCERTAINTIES**

An investment in our securities involves a high degree of risk and should be considered speculative due to the nature of our business and the businesses of our subsidiaries and their current respective stage of development. Before making any decision to purchase or to sell any of our securities, you should carefully consider the complete statement of the risk factors and uncertainties described in the Management's Report and Annual Information Form for fiscal 2010. The Company is pursuing an ongoing risk review and management process.