



A world powered  
by clean energy

**Xebec Adsorption Inc.**

**Management's Discussion and Analysis  
For the three and nine-month periods ended September 30, 2012**

**November 12, 2012**

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

## 1. ABOUT THIS MANAGEMENT DISCUSSION AND ANALYSIS

The following Management's Discussion and Analysis ("MD&A") provides a review of the results of operations, financial conditions and cash flows of Xebec for three-month and nine-month periods ended September 30, 2012. This discussion should be read in conjunction with the information contained in the Company's unaudited consolidated financial statements and related notes for the third quarter of 2012, as well as with the audited consolidated financial statements and related notes for the year ended December 31, 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 financial statements and is expressed in Canadian dollars unless otherwise stated.

In this MD&A, unless otherwise indicated or required by the context, "Xebec", "the Company", "we", "us", "our", "our Company", "the Group" and "our Group" designate, as the case may be, Xebec Adsorption Inc. or Xebec Adsorption Inc. and its subsidiaries. The Company's other subsidiaries are designated as follows: "Xebec SEA" for Xebec Adsorption South East Asia PTE. Ltd. and "Xebec Shanghai" for Xebec Adsorption (Shanghai) Co. Ltd. Also, the fiscal year ending December 31, 2011 and those ended December 31 of prior years are sometimes designated by the terms "fiscal 2011", "fiscal 2010" and so on.

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 IFRS, 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 November 12, 2012, the date on which the Board of Directors approved the consolidated financial statements and Management's Report for the period ended September 30, 2012. 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 2012 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 year ended December 31, 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.

## 2. DESCRIPTION OF THE BUSINESS

### CORPORATE OVERVIEW

**Xebec** Adsorption Inc. ("Xebec" or "the Company") is a Canadian global provider and integrator 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 4 key market and business segments where demand for biogas upgrading, natural gas purification, associated gas purification and hydrogen purification is growing. Headquartered in Montreal (QC), Xebec also operates two manufacturing facilities in Montreal and Shanghai, Sales and services 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:



\* The higher utilization rate of farmland as an energy resource could increase the share of manure, agricultural crops and by-products to 85%, leaving organic waste a 10% and WWTF's a 5% share

Source: Biomass Magazine, Global Water Intelligence, American Biogas Council, Frost And Sullivan, European Biomass Association, Eurostat, Iowa State University

Xebec's head office is in Blainville, Quebec in a 41,753 square foot manufacturing facility in which 75 people are currently employed. The Blainville operation houses corporate finance, sales for natural gas, associated gas and biogas purification products, aftermarket support, global supply

chain, operational engineering, manufacturing of gas separation and purification equipment and service and maintenance support.

As part of the Intellectual Property Transaction disclosed hereafter in the Recent Development section, Xebec has transferred 9 employees and the ownership of its technology center and test laboratory located in Burnaby and Surrey, as well as equipment located in British Columbia. Xebec has maintained the employment of 3 engineers dedicated to sales and service support for Canadian, US west coast and Asian customers.

Xebec's Asian 20,451 square foot manufacturing facility is located in the Song Jiang district of Shanghai, China. This facility employs 30 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 3 people.

**MARKETS**

Xebec mainly targets 4 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
- 4- Associated gas purification

**Natural gas dryers for NGV refueling stations**



**Growing market**

- Cost leadership through Chinese manufacturing

**Key Customers:** Clean Energy, Petrochina, Sinopec, Shell

**Biogas upgrading plants**



**Rapidly growing market**

- High recovery, high purity, low energy plants

**Key Customers:** SEMPRRA, Montauk Energy, Halla Engineering, Terasen Gas

**Hydrogen purifiers for hydrogen recovery**



**Evolving market segment**

- Market-leading performance for small-capacity hydrogen purifiers
- Syngas purification

**Key Customers:** HydroChem, Air Liquide, Linde, Iwatani

**Associated Gas (Oil & Gas industry)**



**Evolving market segment**

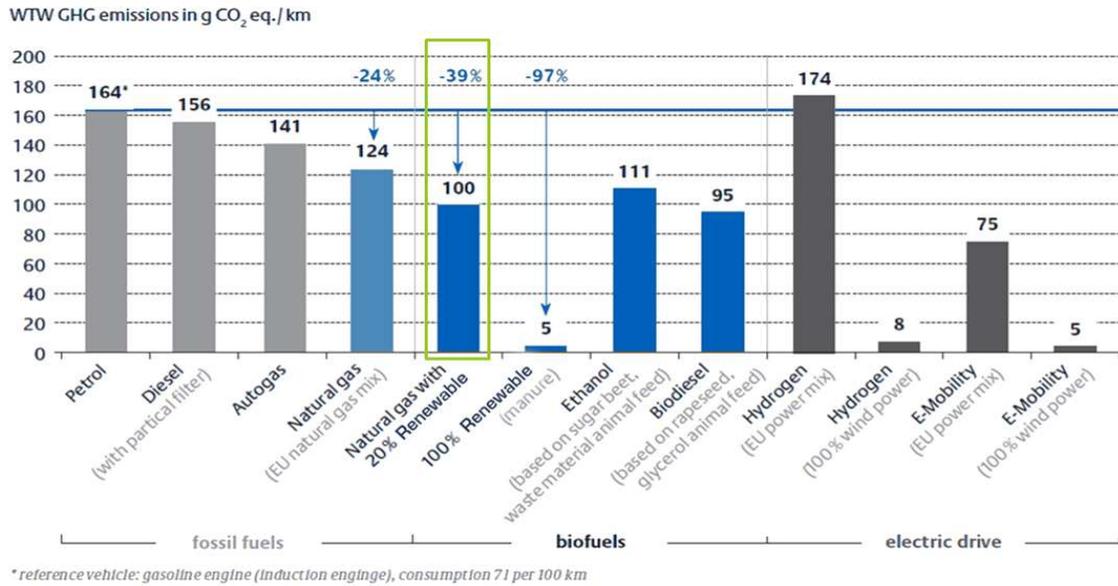
- Market-leading performance for associated gas purification

**Key Customer:** Venocco, Warren

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 low carbon cleaner energy source of 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);
- Gas flaring reduction targets;
- The growing government commitments to renewable energy;
- Diesel displacement in favor of natural gas; and
- Technological advancements.

These market drivers are anticipated to fuel demand for renewable gas. The low cost of natural gas and biogas drives the demand for solutions aimed at displacing diesel and other crude oil derivatives for power applications for transportation and oil rigs, therefore creating new business opportunities for Xebec.



**COMPETITION**

Xebec faces competition within its target markets primarily from other manufacturers of biogas purification, natural gas, associated 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, Acricion 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.

AGX Solutions: In the associated gas market, Xebec's competition includes several membrane equipment suppliers.

### **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 has monetized some its intellectual property portfolio and created additional liquidity to complete its restructuring plan implemented during its 2011 fiscal year;
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 key to the success of the Company, and is currently being addressed.

### **RECENT DEVELOPMENTS**

On October 23, 2012, The Company received additional proceeds of \$1.0 million pursuant to its intellectual property transaction of March 22, 2012. The Company expects to receive further payments over the next 18 months, upon achievement of certain conditions

On October 3, 2012, The Company received two orders valued at approx. \$1.0 million for two high pressure natural gas dehydration and purification units from two Canadian customers. Those units are aimed at industrial scale diesel and heavy fuel oil displacement

On June 26, The Company received its second purchase order for a BGX kinetic landfill gas separation system from China's Golden Green Environmental Engineering & Technical Co. Ltd. (Golden Green). The system will be installed in early 2013 at a landfill in Anshan City. The upgraded landfill gas will be compressed and used as renewable fuel in the transportation sector.

On June 19, the Company signed a co-operative marketing & teaming agreement with Primoris Services Corporation (NASDAQ:PRIM) ("Primoris") to jointly promote and sell a novel proprietary process solution for the associated gas, shale gas and upstream off-gases markets. This process incorporates intellectual property from both Organizations and will be marketed to customers that are involved in exploration and production (E&P), which operate stranded wells or gas processing operations.

On June 5<sup>th</sup>, the Company received a purchase order valued at CAD \$2.05M for an H-3200 fast-cycle Pressure Swing Adsorption (PSA) hydrogen purification unit from Deok-Yang Company Ltd., the leading hydrogen supplier in South Korea.

On May 7th, the Company has successfully completed its initial phase testing for removal of high levels of nitrogen (N<sub>2</sub>) and oxygen (O<sub>2</sub>) in landfill and waste water treatment digester gas. The completion of this new phase test program has allowed the Company to increase its N<sub>2</sub>, O<sub>2</sub> removal capability, and has validated the performance of high nitrogen and oxygen removal of up to 15% nitrogen in the feed biogas.

On April 23<sup>rd</sup>, The Company received its first order for a BGX advanced kinetic landfill gas separation system, which will be installed in early 2013 at a landfill in northern China's Liaoning province. The Company has entered into an exclusive agreement with this leading Chinese environmental engineering firm for the potential delivery of 14 additional upgrading systems over the next 48 months. The value of these medium sized upgrading systems will be in the range of \$1.7 million to \$5.5 million each, depending on the landfill gas flow rates and gas composition.

On March 22<sup>nd</sup>, 2012, the Company sold to Air Products and Chemicals Inc. ("Air products") its intellectual property ("IP") portfolio, including the patents and patent applications relating to its gas separation technology. In this transaction, the Company has also transferred ownership of its research & development facilities in Burnaby and Surrey, as well as other equipment located in British Columbia. Pursuant to this transaction, the Company has received aggregate gross proceeds of CAD\$8,600,000, and net proceeds of approximately CAD\$8,350,000. The transaction is also subject to payments for the achievement of certain conditions to be met within the next 24 months. The Company also entered into a license agreement with Air Products allowing the Company to continue to sell its systems, in the biogas, hydrogen, natural gas and associated gas purification markets

On March 22<sup>nd</sup>, 2012, the Company signed a settlement agreement with Industry Canada for the Government royalty program obligation under TPC (Technology Partnership Canada) with regards to its *Fast Cycle Pressure Swing Adsorption and Gas Management systems* and *Pulsar Pressure Swing Adsorption project*. Under this settlement, the Company paid \$250,000 at the execution of the agreement with Air Products and will reimburse the remaining balance of \$1,000,000 spread over four equal annual payments of \$250,000. Furthermore, the Company has to pay up to \$750,000 in contingent payments based on cumulative funds generated from the license or sale by the Company of its intellectual property.

## CURRENT BACKLOG

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

### Current backlog as of

Product Line:	November 5, 2012	August 2, 2012	May 10, 2012	March 30, 2012
In million of \$				
Natural Gas Dryers	3,3	2,5	1,1	0,8
Gas Purification	8,2	9,7	9,5	9,6
Others	0,3	0,9	0,6	0,7
<b>Consolidated Backlog</b>	<b>11,8</b>	<b>13,1</b>	<b>11,2</b>	<b>11,1</b>

### Major projects included in the current backlog:

#### North America

Name	Type	Location	Commissioning
Fortis BC	Biogas upgrading plant	British Columbia, Canada	H2-2012
Irving Oil Ltd	Natural gas upgrading	New Brunswick, Canada	H1-2013
Primoris	Associated gas upgrading	California, United States	H1-2013
Heritage gas	Natural gas upgrading	Nova Scotia, Canada	H1-2013

#### Europe:

Name	Type	Location	Commissioning
Biogas project developer	Waste Biogas to Biomethane	Austria	H1-2013
Verdemobil	PSA System	France	H1-2013

#### Asia

Name	Type	Location	Commissioning
Grasim Industries limited	PSA System	India	H2-2012
Deok-Yang Company Ltd	PSA System	South Korea	H1-2013
Potlatch Inc.	Biogas upgrading plant	South Korea	H1-2013
Golden Green	Biogas upgrading plant	China	H1-2013
Golden Green #2	Biogas upgrading plant	China	H2-2013
Heilongjiang Loonggas	Biogas upgrading plant	China	H2-2013

### 3. SELECTED CONSOLIDATED QUARTERLY INFORMATION

#### Three-Month and Nine-Month Periods Ended September 30, 2012 and 2011

(in million of \$, except per-share amounts) (unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Revenues	3,7	2,9	9,4	11,5
Gross margin	30,4%	42,0%	20,9%	35,7%
EBITDA	(0,5)	2,3	3,3	1,7
Net income (loss)	(0,7)	1,7	1,7	2,0
Net income (loss) per share - basic (\$/share)	(0,02)	0,04	0,05	0,01
Net income (loss) per share - diluted (\$/share)	(0,02)	0,04	0,04	0,01

Balance Sheet Data	September 30		December 31	
	2012	2011	2011	2010
Total assets	9,9	10,3		
Shareholder's equity	1,9	(0,3)		
Total long-term financial liabilities	1,3	1,3		
Cash, cash equivalents	1,5	0,4		

### 4. OPERATING RESULTS

#### Analysis of Consolidated Operating Results for the Third Quarter of 2012 Compared with the Third Quarter of 2011

##### Consolidated Revenues by Product Line (unaudited)

In millions of \$	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Gas purification	2,2	1,6	5,2	4,5
Natural gas dryers	0,9	0,6	2,1	2,7
Compressed gas filtration	0,6	0,3	1,6	1,2
Engineering services	-	0,3	0,4	1,4
Licensing	-	-	-	1,5
Air dryers	-	0,1	0,1	0,2
<b>Total</b>	<b>3,7</b>	<b>2,9</b>	<b>9,4</b>	<b>11,5</b>

**Consolidated revenues** for the third quarter of 2012 grew by \$0.8 million or 28% to \$3.7 million. This growth is due mainly to the \$0.7 million or 47% increase in sales of gas purification units. The Company recognized revenue for two major projects this quarter compared to only one last year. All product line showed increased in revenues this quarter compared to the last fiscal year. Working capital deficiencies worsened during August of last year and affected the completion of projects.

For the first nine months, revenues declined by \$2.1 million or 18%. However, licensing revenues of 1,5M\$ were non-recurrent and engineering services are no longer carried out by the Company following the March 22, 2012 IP transaction. Furthermore, the Company was unable to complete deliveries of its backlog, due to working capital deficiencies.

In the short and medium term, the future of natural gas as an alternative to crude oil remains very positive. Green energy initiatives are on the agendas of municipal, provincial and federal governments worldwide. Corporations and consumers are increasingly looking for cost efficient green energy solutions to reduce their costs, with the added benefit of protecting 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.

The Company's immediate efforts are primarily focused on maintaining its market position, addressing and managing its liquidity and working capital requirements. Xebec is well positioned to capture market share in the expanding biogas upgrading and associated gas markets.

### **Operating profit margin**

	Three months ended September 30,		Nine months ended September 30,	
In millions of \$	2012	2011	2012	2011
Revenues	3.7	2.9	9.4	11.5
Cost of Goods Sold	2.6	1.7	7.5	7.4
Gross Profit*	1.1	1.2	1.9	4.1
Gross Profit Margin (%)	30.4%	42.0%	20.9%	35.7%

**The operating profit margin** for the third quarter of 2012 stood at 30%, down from 42% for the third quarter of 2011. Margins were down by 12% for three-month period ended September 30, 2012 compared to the same period of the previous year. The decline versus the same period last year is mostly explained by the recognition of the profit upon delivery of our second biogas plant. The Company took a conservative approach given its experience at that time on previous biogas plants and deferred margins recognition until the completion of the project which happened in the third quarter of the previous fiscal year.

**Selling and administrative expenses** for third quarter of 2012 increased by \$0.4 million or 40% to \$1.6 million. The Company hired new employees throughout the current year to rebuild its workforce thus more people were employed this quarter over the same quarter of last year. Furthermore, commission expenses increased compared last year as we have more ongoing projects.

For the first nine month of 2012 selling and administrative expenses decreased by \$0.4 million or 9%. The decrease in selling and administrative expenses is the result of the company's restructuring and the implementation of cost control measures and the reduction of professional fees. Moreover, the company had to pay a non-recurring \$0.1 million in recruiting fees to rebuild its engineering team.

**Research and development expenses, net of research and tax credits** for the third quarter of 2012 and the first nine months decreased by \$0.08 million or 79% and \$0.45 million or 91% respectively to \$0.02 million and \$0.04 million due to the reduction in headcount in research and development department. These reductions can also be explained by the decrease in patents maintenance costs as the Company assigned them to Air products. Most employees are now assigned to production. Most employees are now assigned to production. Nonetheless, the Company is maintaining its research capability through various partnerships with public and private research labs.

**EBITDA**

In millions of \$	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Net income (loss)	<b>(0.7)</b>	1.7	<b>2.0</b>	0.5
Depreciation of property	-	0.1	<b>0.1</b>	0.3
Amortization of intangible assets	<b>0.1</b>	0.2	<b>0.3</b>	0.4
Share-based compensation expense	<b>0.1</b>	0.1	<b>0.1</b>	0.1
Finance cost net	-	0.2	<b>0.8</b>	0.4
EBITDA (loss)	<b>(0.5)</b>	2.3	<b>3.3</b>	1.7

\* EBITDA is a non-IFRS financial measure.

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 a 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.

**EBITDA** for third quarter in 2012 declined by \$2.8 million or 122% to \$(0.5) million. The decline is mainly explained by a gain of \$2.3 million on the sale of the company's headquarters in Blainville during the third quarter 2011 which is not recurrent. The decrease in the EBITDA is explained by the lower margin realized on the gas purification units as intensive efforts were deployed to finalize the Company's third biogas plant that shipped at the end of the quarter. This delivery hindered progress on the others ongoing projects.

For the first nine month in 2012, EBITDA improved by \$1.6 million or 94% to \$3.3 million. The improvement in the EBITDA is the result of the one-time gain on the disposition of the IP portfolio to Air Products and lower overhead expenses due to the implementation of cost control measures despite the fact that gross margin is significantly lower than last year.

**Financial net expenses** for third quarter of 2012 decreased by \$0.2 million or 104% decreased due to the reimbursement of most of the debt at the end of Q1-2012 and a better management of credit.

For the first nine months of 2012, financial expenses increased by \$0.4 million or 78% due to the loss on revaluation of \$0.7 million for the Technology Partnerships Canada program (See "Contingent Off-Balance-Sheet Financing Arrangements" below for more details) due to the settlement agreement between the Company and Industry Canada. However, Investment Quebec's long term debt repayment and new agreement with Industry Canada reduced interest expense by \$0.3 million.

**Net income (loss)**

Net loss for the three-month period ended September 30, 2012 was \$0.6 million, or \$0.02 per share, compared to a net income of \$1.8 million, or \$0.04 per share, for the same period in 2011, reflecting primarily an increase in selling and administrative expenses of \$0.4 million and a slower progression on gas purification projects due to the concentrated efforts on the shipment of the Company's third biogas plant during the period.

Net income for the nine-month period ended September 30, 2012 was \$2.0 million, or \$0.05 per share, compared to a net income of \$0.5 million, or \$0.01 per share, for the same period in 2011, reflecting primarily a \$5.4 million gain on the sale of the Company IP portfolio to Air Products and cost reductions of \$0.4 million for selling and administrative expenses due to a decrease of professional fees and payroll. However, this gain was offset by a \$2.1 million gross margin reduction and an increase in financial expenses of \$0.4 million due to the loss on the revaluation of the Technology Partnerships Canada program.

**Principal Quarterly Financial Information**

(in thousands of \$, except per-share amounts) (unaudited)

	2012			2011				2010
	Q3	Q2	Q1	Q4	Q3*	Q2	Q1	Q4
Revenues	3.7	4.2	1.5	2.7	2.9	4.5	4.1	3.4
Net income (loss)	(0.6)	(0.5)	3.2	(2.0)	1.7	(1.0)	(0.2)	(3.9)
Earnings (loss) per share basic and diluted	(0.02)	(0.01)	0.08	(0.02)	0.02	(0.03)	-	(0.11)

\*restated

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

**FINANCIAL POSITION**

***Analysis of Principal Cash Flows for the Third Quarter and Nine-Month Period of Fiscal 2012 (unaudited)***

Cash flow from (used in)	Three months ended			Nine months ended		
	September 30,			September 30,		
in millions of \$	2012	2011	Change	2012	2011	Change
Operating activities	(0,4)	(0,8)	0,4	(5,8)	(3,0)	(2,8)
Investing activities	(0,1)	2,0	(2,1)	8,3	2,5	5,8
Financing activities	-	(1,7)	1,7	(1,5)	(1,7)	0,2

**Operating activities** In the third quarter of 2012, the operating activities used \$0.4 million of cash, compared to \$0.8 million for the same period in 2011. The decrease in uses of cash is mainly due to the implementation of cost control measures and an improvement of our operations. For the nine-month period ended September 30, 2012 operating activities used \$5.8 million of cash, compared to \$3.0 million for the same period last year. The decrease of \$3.2 million is mainly explained by the decrease of gross margin by \$2.1 million and a decrease of our accounts payable as the Company paid down its suppliers after the closing of its IP transaction.

**Investing activities** Investing activities used \$0.1 million of cash in the third quarter of 2012, compared to a cash inflow of \$2.0 million for the corresponding third quarter of 2011 mainly explained by the sale and lease back of the Company's headquarters in Blainville. For the nine-month period ended September 30, 2012 investing activities generated \$8.3 million of cash, compared to \$2.5 million for the same period last year. The increase is mainly explained by the disposition of the IP assets related to the transaction with Air Products in March 2012.

**Financing activities** In the third quarter of 2012, the financing activities used \$48,918, compared to \$1.7 million for the same period of 2011. The decrease is mainly explained by the repayment of its debts pursuant to the sale and lease back of its headquarters in Blainville. For the nine-month period ended September 30, 2012 financing activities used \$1.5 million of cash, compared to \$1.7 million for the same period last year. The decrease in financing is explained by the repayments of the bank loan of \$0.5 million and Investissement Quebec's long term debt of \$0.1 million upon closing of the sale of IP assets to Air Products in March 2012. The Company reached a settlement agreement with The Technology Partnerships Canada program and a repayment of \$0.8 million has been made in March 2012.

As of September 30, 2012, the Company had \$1.5 million of cash on hand and \$1.2 million of long-term debt outstanding, of which \$0.3 million is due within one year.

**Balance Sheet Analysis as at September 30, 2012**  
**Summary Balance Sheet** (unaudited)

	September 30 2012	December 31 2011
Current assets	\$ 7.8	\$ 4.6
Long-term assets	2.1	5.7
	\$ 9.9	\$ 10.3
Current liabilities	\$ 6.7	\$ 9.2
Long-term liabilities	1.3	1.4
Shareholders' equity	1.9	(0.3)
	\$ 9.9	\$ 10.3

The change in the company's balance sheet between September 30, 2012 and December 31, 2011 reflects the disposition the intellectual property ("IP") portfolio in Q1-2012 which contributed to an increase in cash, in short term asset and has reduced long term assets by the value of the IP as recorded within the intangible asset. The Company is now operating at full capacity compared to 2011 due to the working capital deficiencies which are reflected in the increase in sale and account receivable. Upon closing of the sale of IP assets to Air products, bank loans were reimbursed and a significant amount of aged accounts payable was paid down.

As at September 30, 2012 **total assets** amounted to 9.9 million, down by \$0.4 million from December 31, 2012. **Working capital** stood at \$1.1 million for a current ratio of 1.2:1 compared with \$(4.6) million and a 0.5:1 ratio as at December 31, 2011.

**Shareholders' equity** totalled \$1.9 million as at September 30, 2012 up by \$2.2 million from December 31, 2011. The change is mainly due to the gain resulting from the IP transaction with Air products in March 2012 which decreased the deficit.

**Indebtedness**

	September 30 2012	December 31 2011
Bank loans	\$ -	\$ 0.5
Current portion of long-term debt	0.3	0.3
Long-term debt	0.9	1.0
Total indebtedness <sup>(1)</sup>	\$ 1.2	\$ 1.8

**Total interest-bearing debt** (bank loans, current portion of long-term debt and long-term debt) amounted to \$0.05 million as at September 30, 2012, down by \$0.6 million from December 31, 2012. This reduction is due primarily to the repayments of the bank loan and the principal repayment of Investment Quebec's long term debt.

**Credit Facilities**

As at September 30, 2012, the Company had credit facilities in the amount of \$1.3 million with the Royal Bank of Canada which bore interest at the Company's bank's prime rate plus 2.50% per annum and which were limited by certain margin requirements concerning accounts receivable. The Company had also a revolving demand facility by way of letters of credit and letters of guarantee amounting to \$750,000. However, as at September 30, 2012, the Company was not allowed to draw on these facilities and they are currently being renegotiated.

In addition, the Company had access to credit facilities in the amount of \$500,000 with Royal Bank of Canada which were guaranteed by Export Development of Canada and bore interest at the Company's bank's prime rate plus 2.5% per annum and were limited by certain requirements

concerning pre-shipment costs. However, as at September 30, 2012, the Company was not allowed to draw on these facilities and they are currently being renegotiated.

The bank loan is secured by a first ranking hypothec of \$4,000,000 on all movable property of the Company.

The credit facilities with the Royal Bank of Canada matured on October 31, 2010 and have been verbally extended under certain conditions on an "as needed" basis. The agreement with Export Development of Canada had been extended under the same terms and conditions until April 30, 2012 and is currently being renegotiated.

### **Capital Stock Information**

The authorized share capital of the Company consists of an unlimited number of common shares and an unlimited number of preferred shares.

As at September 30, 2012 and November 12, 2012, Xebec had 39,363,867 common shares issued.

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

As at September 30, 2012, 10,091,886 Share Purchase Warrants were outstanding and entitle the holder to acquire one Common Share at a price of \$0.45 per share until November 2nd 2015.

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***

The Company 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 September 30, 2012, the maximum number of common shares available for issuance under all stock-based compensation arrangements is 3,936,387.

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 September 30, 2012, the Company had 3,455,514 options outstanding under the plan with a weighted average exercise price of \$0.19.

**Contractual Commitments**

The following table is a summary of the contractual obligations including payments due for each of the next five years and thereafter:

	Payments Due by Period			
	1 year	2 -5 years	Beyond 5 years	Total
Debt repayments <sup>(1)</sup>	0,1	0,1	-	0,2
Government royalty program obligation <sup>(2)</sup>	0,2	0,7	-	0,9
Operating leases	0,5	1,3	2,9	4,7
Software licenses agreements	0,1	0,3	-	0,4
<b>Total contractual obligations</b>	<b>0,9</b>	<b>2,5</b>	<b>2,9</b>	<b>6,3</b>

There have been no significant changes in the contractual obligations of the Company since its MD&A for the three and twelve-month period ended December 31, 2011 issued on March 30, 2012.

**FINANCIAL AND OTHER INSTRUMENTS**

***Credit Risk***

Credit risk is the risk of an unexpected loss if a customer or third party fails to meet its contractual obligations. The Company's primary credit risk is its cash and outstanding trade accounts receivable. The carrying amount of its outstanding trade accounts receivable represents the Company's estimate of its maximum credit exposure. The Company regularly monitors its credit risk exposure and takes steps such as employing credit-approval procedures, establishing credit limits, using credit assessments and monitoring practices to mitigate the likelihood of these exposures from resulting in an actual loss. An allowance for doubtful accounts amounting to \$171,777 (2011 – \$194,273) was established, based on prior experience and an assessment of current financial conditions of customers as well as the general economic environment. In the case where an allowance for doubtful accounts provision is recorded and a receivable balance is considered uncollectible, it is written off against the allowances for doubtful accounts. Bad debt expense amounted to \$(21,315) for third quarter in 2012 and \$(900) for the period ended September 30, 2012 (corresponding period in 2011 respectively – \$ (20,920) and \$(101,652)). As at September 30, 2012, the Company's three largest trade debtors accounted for 28% (14%, 7% and 7%) of the total accounts receivable balance (2011 – 28% (11%, 9% and 8%)).

***Currency Risk***

Some assets and liabilities are exposed to foreign exchange fluctuations. The Company does not use financial instruments to reduce this risk.

***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 September 30, 2012 is nil (2011 - \$500,000) and the long-term debt that is subject to the variability of the interest rate fluctuation is \$ nil (2011 - \$ nil).

If the interest rate on the bank debt had been 50 basis points higher (lower), related to the bank loan as at September 30, 2012, net loss would have been nil for the third quarter of 2012 and

\$625 for the nine-month period ended September 30, 2012 (corresponding period 2011 –\$625 and \$1,875 respectively) higher (lower).

### **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

In our 2011 annual consolidated financial statements and notes thereto, as well as in our 2011 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

#### ***Recent Accounting Pronouncements***

(i) IFRS 9, Financial Instruments, issued in November 2009, is mandatory for accounting periods beginning after January 1, 2015 and addresses classification and measurement of financial assets. It replaces the multiple category and measurement models in IAS 39, Financial Instruments – Recognition and Measurement for debt instruments with a new mixed measurement model having only two categories: amortized cost and fair value through profit or loss. IFRS 9 also replaces the models for measuring equity instruments. Such instruments are either recognized at fair value through profit or loss or at fair value through other comprehensive income. Where equity instruments are measured at fair value through other comprehensive income, dividends are recognized in profit or loss to the extent that they do not clearly represent a return of investment; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely.

Requirements for financial liabilities were added to IFRS 9 in October 2010 and they largely carried forward existing requirements in IAS 39, Financial Instruments – Recognition and Measurement, except that fair value changes due to credit risk for liabilities designated at fair value through profit or loss are generally recorded in other comprehensive income. IFRS 9 is applicable to the Company for the year beginning on January 1, 2015, with earlier application permitted.

(ii) IFRS 10, Consolidated Financial Statements, requires an entity to consolidate an investee when it has power over the investee, is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC 12, Consolidation—Special Purpose Entities, and parts of IAS 27, Consolidated and Separate Financial Statements.

(iii) IFRS 11, Joint Arrangements, requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation, the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity account for interests in joint ventures. IFRS 11 supersedes IAS 31, Interests in Joint Ventures, and SIC 13, Jointly Controlled Entities—Non-monetary Contributions by Venturers.

(iv) IFRS 12, Disclosure of Interests in Other Entities, establishes disclosure requirements for interests in other entities such as subsidiaries, joint arrangements, associates and unconsolidated structured entities. The standard carries forward existing disclosures and also introduces significant additional disclosures that address the nature of, and risks associated with, an entity's interests in other entities.

(v) IFRS 13, Fair Value Measurement, is a comprehensive standard for fair value measurement and disclosure for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and does not always reflect a clear measurement basis or consistent disclosures.

(vi) IAS 1, Presentation of Financial Statements, has been amended to require entities to separate items presented in other comprehensive income into two groups, based on whether or not items may be recycled in the future. Entities that choose to present other comprehensive income items before tax will be required to show the amount of tax related to the two groups separately.

**Related party transactions**

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

	For the three-month ended September 30,		For the nine-month ended September 30,	
	2012	2011	2012	2011
	\$	\$	\$	\$
Marketing and professional services expenses accrued to companies controlled by members of the immediate family of an officer	15,437	11,946	51,070	26,529
Sales to a shareholder of a subsidiary (a joint venture partner in 2011)	3,579	32,984	21,992	73,588
Accrued interest to a joint venture partner	-	-	-	854
Accrued interest on a loan from a Company director	163	-	1,841	-
Repayment of loan from a Company director	24,123	-	24,123	-

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 September 30, 2012, 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 annual or any interim consolidated financial statements for fiscal 2012 and 2011. 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 of our subsidiaries. These manual procedures were performed during the interim periods ended September 30, 2012 and 2011.

### ***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 September 30, 2012. 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 2012 and 2011. 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 and of our subsidiaries. These manual procedures were performed for the periods ended September 30, 2012 and 2011.

### *Unusual Transactions*

We detected unusual transactions in our subsidiary Xebec Shanghai during a routine audit. These transactions have a non material impact on the Company's interim consolidated financial statements as at September 30, 2012 and September 30, 2011. A Xebec Shanghai management employee involved in these unusual transactions has since been dismissed.

### ***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 September 30, 2012.

### *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.

### *Unusual transaction*

In addition to dismissing the Xebec Shanghai management employee involved in the said transactions, the Company hired a new controller at Xebec Shanghai with the specific mandate of tightening controls within this subsidiary. Furthermore, we implemented a new accounting system and we dispatched a full time expatriate to oversee this subsidiary. An internal investigation is also underway with respect to these transactions.

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 ICFF. 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 2012 or any previous periods, except for the restatement of our third quarter 2011.

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 September 30, 2012 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 2011. The Company is pursuing an ongoing risk review and management process.