

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THE FOLLOWING DISCUSSION AND ANALYSIS OF OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS SHOULD BE READ IN CONJUNCTION WITH OUR FINANCIAL STATEMENTS AND RELATED NOTES. OUR FINANCIAL STATEMENTS ARE PRESENTED IN U.S. DOLLARS. WE PREPARE OUR FINANCIAL STATEMENTS IN ACCORDANCE WITH CANADIAN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES. WE ARE TRANSITIONING FROM A LATE STAGE DEVELOPMENT COMPANY TO AN EARLY STAGE COMMERCIAL MANUFACTURER.

THIS ANNUAL REPORT CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE A NUMBER OF RISKS AND UNCERTAINTIES, INCLUDING STATEMENTS REGARDING THE OUTLOOK FOR THE COMPANY'S BUSINESS AND RESULTS OF OPERATIONS. BY NATURE, THESE RISKS AND UNCERTAINTIES COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE INDICATED. SUCH FACTORS INCLUDE, WITHOUT LIMITATION, THE VARIOUS FACTORS SET FORTH IN THE MANAGEMENT'S DISCUSSION AND ANALYSIS OF THIS REPORT AND AS DISCUSSED IN PUBLIC DISCLOSURE DOCUMENTS FILED WITH CANADIAN REGULATORY AUTHORITIES.

ELECTROFUEL DISCLAIMS ANY INTENTION OR OBLIGATION TO UPDATE OR REVISE ANY FORWARD-LOOKING STATEMENTS, WHETHER AS A RESULT OF NEW INFORMATION, FUTURE EVENTS OR OTHERWISE.

❖ BUSINESS OF THE COMPANY

Electrofuel has developed a proprietary advanced alternative power technology which we believe has a broad spectrum of potential applications. We call this technology our SuperPolymer technology, and we believe that it enables us to produce portable rechargeable batteries that have significantly longer run times for their size and weight than any rechargeable batteries currently in commercial production.

We were founded in September 1996. Our founders, Dr. Sankar Das Gupta and Dr. James K. Jacobs, began work on lithium rechargeable battery technology in 1983, and in 1987 they incorporated The Electrofuel Manufacturing Company Ltd. to undertake a variety of technology development projects, including a lithium ion battery development project. From 1987 to September 1996, The Electrofuel Manufacturing Company Ltd. was engaged in the business of manufacturing ceramic cutting tools and ceramic components, high temperature furnaces, furnace parts and instruments for materials processing. The Electrofuel Manufacturing Company Ltd. was also engaged in the research and development of a number of potential new technologies including advanced ceramic materials, glow plugs for diesel engines, fire retardant materials and battery technologies, one of which was the lithium ion polymer battery technology. Recognizing the potential commercial applications of lithium ion polymer battery technology, Drs. Das Gupta and Jacobs decided to form a new company, Electrofuel Inc., to engage exclusively in the development and commercialization of that technology. As a result, in October 1996, we acquired patents and patent applications with respect to the rechargeable lithium ion polymer battery technology from Drs. Das Gupta and Jacobs and, in January 1997, we acquired all assets relating to the lithium ion polymer battery technology from The Electrofuel Manufacturing Company Ltd. By the end of calendar 1997, The Electrofuel Manufacturing Company Ltd. had wound down its manufacturing operations and other development projects, although it retained all of the assets not acquired by us.

In January 1997, we completed a private placement in Canada and used the net proceeds of \$6.5 million from the offering to continue the development of our lithium ion battery technology, develop products that utilize this battery technology, improve our research and development, establish a low-volume production facility and fund

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

operations. In June 1999, we introduced our first commercial product, the PowerPad 160, a rechargeable lithium ion polymer battery designed for external use with portable computers. We have since produced limited quantities of the PowerPad 160 for marketing, testing and sales. In February 2000, at the Wireless 2000 trade show, we exhibited our prototype EF2100 mobile phone battery which, based on our internal testing, is compatible with Nokia 5000 and 6000 series mobile phones. We have produced a limited number of samples of this product, which we are currently testing.

In January 2000, we raised net proceeds of approximately \$28.4 million through the private placement of special warrants in Canada, the United States and Europe. These proceeds are being used, in part, to acquire and equip our manufacturing facility in Mississauga, Ontario. We expect the Mississauga facility to be operational in the second calendar quarter of 2001 and have a monthly production capacity of approximately five million watt hours, which is equivalent to approximately 30,000 PowerPad 160 units.

In November 2000, we completed a public offering of 6,250,000 common shares providing net proceeds of \$28.3 million. With the proceeds of this offering, we intended to expand the Mississauga facility by the end of September 2001 in order to achieve a monthly production capacity of approximately 10 million watt hours, at a cost of approximately \$15 million. We also planned to use the proceeds from that offering toward establishing a second manufacturing facility by the end of calendar 2001.

During the year ended September 30, 2000, we added engineering and research and development staff, filled key senior management positions and raised equity capital. In February 2000, we acquired machinery and equipment from an industrial machine-building company in the Toronto area for \$1.1 million to provide us with the internal capability to manufacture the proprietary equipment we require to make our products.

During the same period, we devoted resources toward acquiring a site and building the equipment for our Mississauga manufacturing facility, research and development relating to new products and marketing efforts to create awareness of the PowerPad 160 product and our technology. Our employee base has increased significantly during this period, and we expect further increases in personnel during the next 12 months as we begin commercial production of the PowerPad 160 and continue to develop and expand our product offering.

❖ RESULTS OF OPERATIONS

Year ended September 30, 1999 compared to year ended September 30, 2000

Sales

Sales for the year ended September 30, 2000 were \$152,319, consisting of sales of PowerPad 160 units from our low-volume production facility in Toronto to blue chip corporate customers, distributors, and individuals. There were no sales in the year ended September 30, 1999. We recognize revenue on the sale of commercial units produced at the Company's low-volume production plant at the time the units are shipped to customers. This plant is principally used to support the Company's research and development initiatives. All of the material and labor costs associated with the production of the commercial units have been charged to research and development expenses.

Operating Expenses

Research and Development Research and development expenses consist primarily of compensation and related costs for research and development personnel, including independent contractors and consultants, direct materials and allocated overhead.

Research and development expenses, net of investment tax credits, increased from \$714,115 for the year ended September 30, 1999 to \$1.0 million for the year ended September 30, 2000. This increase in net research and development expenses reflects the higher costs associated with the development of our PowerPad 160 for portable computers, including the hiring of additional research and development personnel and the increased allocation of existing personnel to research and development efforts.

General and Administrative General and administrative expenses include salaries and benefits for corporate personnel, professional fees and facilities expenses, net of any allocation to research and development activities. Our corporate administrative staff includes our executive officers and employees engaged in business development, financial planning and control, legal, human resources and corporate administration.

General and administrative expenses increased from \$614,495 for the year ended September 30, 1999 to \$1.9 million for the year ended September 30, 2000. This increase reflects an increase in corporate staff, legal and consulting fees and depreciation expense.

Sales and Marketing Sales and marketing expenses increased from \$225,592 for the year ended September 30, 1999 to \$828,849 for the year ended September 30, 2000. This increase reflects higher spending for marketing personnel, trade shows, advertising and other marketing costs related to our PowerPad 160 and other products, as well as building awareness of our technology.

Other Income

Our other income has been derived primarily from the provision of consulting, development and engineering support services to third parties. Other income increased from \$90,052 for the year ended September 30, 1999 to \$129,728 for the year ended September 30, 2000.

Interest Income

Interest income increased from \$149,599 for the year ended September 30, 1999 to \$1.1 million for the year ended September 30, 2000. We derived interest in both periods from cash and short-term investments. This increase primarily reflects the additional interest derived from the unused portion of the proceeds from our January 2000 special warrant financing.

Foreign Exchange Gain or Loss

The gain or loss on foreign exchange increased from a loss of \$1,233 for the year ended September 30, 1999 to a gain of \$853,100 for the year ended September 30, 2000. This was due primarily to the U.S. dollar increasing relative to the Canadian dollar from January 2000 to September 2000. As a result of the special warrant financing completed in January 2000 in U.S. dollars, we were holding more U.S. dollar denominated interest-bearing investments.

❖ **LIQUIDITY AND CAPITAL RESOURCES**

Since inception, we have financed our operations primarily through private placements of our securities, and as of September 30, 2000, we had raised aggregate net proceeds of \$34.9 million. As of September 30, 2000, we had \$19.3 million in cash and short-term investments.

Net cash used in operating activities was \$1.0 million for the year ended September 30, 1999 and \$411,716 for the year ended September 30, 2000. Net cash used in operating activities for the year ended September 30, 2000 reflects the operating loss of \$1.5 million offset by amortization of \$449,468, common shares issued for services in the amount of \$176,042, and a decrease in non-cash working capital of \$481,023. The decrease in non-cash operating working capital was principally attributable to an increase in accounts payable and accrued liabilities, relating to legal and other expenses for the public offering of shares.

Cash provided by financing activities was \$26.1 million for the year ended September 30, 2000, compared to none for the year ended September 30, 1999. These financing activities consisted primarily of private placements of our securities.

Cash used in investing activities was \$498,533 for the year ended September 30, 1999 and \$20.9 million for the year ended September 30, 2000. Cash used in investing activities reflects the purchase of the Mississauga facility for \$2.6 million, building improvements of \$1.1 million, \$3.7 million in machinery and equipment for the Mississauga plant and the machine building operation in Vaughan, Ontario, and an investment in short-term securities of \$13.0 million.

We have recorded net losses in every year since our inception. As we continue to make investments in product development and marketing activities, we expect to incur net losses at least through our fiscal year ending September 30, 2001. In the current and future quarters, we expect significant increases in expenses in all categories. We expect research and development expenses to increase as we continue to develop our portable computer and mobile phone battery product lines and explore other potential applications for our technology. We also expect our sales and marketing and general and administrative expenses to increase as we expand our capabilities in these areas and increase our corporate infrastructure to support the growth of our business in anticipation of high-volume production. We currently plan to fund these expenses with cash on hand and the proceeds from the equity offering completed in November.

We have not yet received significant revenue from the sale of our batteries. Since June 2000, we have sold limited quantities of the PowerPad 160. After we begin larger scale commercial production of our PowerPad products, which we expect to occur in the second calendar quarter of 2001, we expect that our principal source of revenue will be the sale of our battery products. Initially, we expect that our sales will be concentrated among a limited number of customers.

We expect we will continue to experience negative cash flow in the future and our capital expenditures will continue to increase significantly as we expand our manufacturing capability. Our future liquidity and capital requirements will principally depend on our rate of growth and the means by which we achieve our growth. We believe that the net proceeds from the sale of our common shares in November, together with cash on hand, will be sufficient to meet our requirements until at least December 2001. We expect to need additional capital beyond December 2001, which we may not be able to raise on favorable terms, or at all. Our capital needs in future periods will depend principally on our ability to generate sales of our products, the extent and timing of future increases in manufacturing capacity and the extent to which we engage in acquisitions and joint ventures. We believe we may be able to adjust the timing and extent of capital investment if additional capital is not available to us.

❖ RECENT ACCOUNTING PRONOUNCEMENTS

The Canadian Institute of Chartered Accountants has issued new accounting standards for “earnings per share,” which are effective for our fiscal year commencing October 1, 2001. This new standard uses the Treasury Stock method instead of the imputed interest approach for determining the dilutive effects of warrants, options, and similar instruments. Under this method, our basic loss per share is unaffected and our options are anti-dilutive.

❖ QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT RISKS AND UNCERTAINTIES

Interest Rate Risk

As of September 30, 2000, we had cash and short-term investments totaling \$19.3 million which consisted of cash and cash equivalents of \$6.3 million, including investments with original maturities of two months or less at the date of purchase, and \$13 million of short-term commercial paper with maturity of 123 days at the time of acquisition. These securities bear interest at a weighted average rate of 6.5%. As a result of their short-term maturities, we do not believe these investments are subject to significant interest rate risk. Declines in interest rates over time will, however, reduce the interest income earned on surplus cash balances.

Pending our specific uses, we expect to invest the proceeds of the offering in investment grade short-term marketable securities.

Foreign Currency Exchange Rate Risk

We expect that the majority of our sales will, in the future, be made in U.S. dollars and that in the short term, the majority of our expenses will be denominated in Canadian dollars. In addition, short-term investments consist of \$13.0 million in U.S. deposits. Fluctuations in the exchange rate between the Canadian dollar and the U.S. dollar may therefore have a material effect on our results of operations. We do not currently engage in currency hedging activities.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Credit Risk

Once we commence commercial operations, we expect to manage our credit risk with respect to accounts receivable by establishing and implementing credit limits, approval policies, and primarily dealing with large creditworthy customers. However, we believe that, at least initially, we will be subject to significant concentration of credit risk since our sales will be to a limited number of customers, some of whom we have no previous dealings with.

Other Risks and Uncertainties

We are a development stage company facing corresponding risks, expenses and difficulties that may affect our outlook and eventual results of our business and commercialization plan. We may not be able to establish high-volume manufacturing facilities on a timely, cost-effective basis or at all. We have never manufactured batteries in large quantities and we may not be able to maintain future commercial production at planned levels. Additionally, if we are unable to secure an adequate supply of raw materials or components, our costs could increase or our production could be limited.

We plan to offset these risks in a number of ways:

Our manufacturing process is modular, consisting of numerous discrete unit processes. Our high-volume facility will utilize machinery and equipment that is similar to the machinery and equipment that we have already designed, built and used in our current low-volume production plant. Since the introduction of our PowerPad in 1999 we have successfully produced finished products in our pilot plant, resulting in sales. We are in the process of formalizing supply arrangements with suppliers to ensure that raw materials required for high-volume production are available at a reasonable cost and on a timely basis. We intend to have more than one supplier for critical raw materials and components.

Until the establishment of multiple plants, we will be dependent upon the operation of a single manufacturing facility and accidents or other operational problems at this facility could affect our ability to deliver product to our customers and therefore our ability to generate revenues. In addition, we may be subject to environmental liabilities at our facilities, which could result in material expense and adversely affect our ability to sell or finance our facilities.

We have addressed these risks by designing and building our high-volume facility with worker safety in mind. In addition, we are adopting a formal environmental policy that requires compliance with environmental legislation and an ongoing program of monitoring our environmental compliance.

We do not have a collaborative partner to assist us in the development of our batteries, which may limit our ability to develop and commercialize our products on a timely basis, if at all. Furthermore, we may incur significant costs and invest considerable resources designing and testing batteries for use with, or incorporation into, specific products without significant return.

We believe that the formation of strategic partnerships will be important for the Company to meet its business objectives. We will continue to seek arrangements with potential partners to mitigate the development and commercialization risk going forward, balanced by our objective to maximize market share and penetration by not entering into exclusivity arrangements with a single partner. In addition, we are reviewing options to work with multiple partners on OEM programs for internally designed applications, sales and distribution arrangements, outsourcing parts of our manufacturing process, and for development of specialized applications in industry segments other than portable computers and mobile phones.

We may not be able to compete effectively with other manufacturers of compact rechargeable batteries. There is also the possibility our competitors may develop portable power technologies that match or outperform our SuperPolymer technology, which may diminish the demand for our products. In addition, innovations in the design of portable computers, mobile phones and other wireless devices may reduce the need for our batteries.

We believe we are well positioned to compete in the market for compact rechargeable batteries, which is already very large and growing rapidly. There are currently five to seven principal competitors, primarily well capitalized companies based in Japan, who have in aggregate a dominant market position in the lithium ion and lithium ion polymer battery sector. By leveraging our technological advantage, moving quickly to penetrate the market, initially targeting the underserved aftermarket, and emphasizing our higher energy density to create brand differentiation, we believe we can achieve revenue generation in the near term. Additionally, we believe that design innovations in the wireless sector will either not materially extend the run time of existing battery technologies or will be more than offset by the addition of new, enhanced, power-hungry features, which will increase the energy requirements of these wireless devices.

While our energy density is currently superior to that of our competitors in commercial production, we will continue to invest in research and development to utilize latest generation advanced materials and improve the process and design of our batteries to maintain or widen the technological gap between our technology and our closest competitors. However, we have limited knowledge of our competitors' activities in this area.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

We are exposed to certain risks as a result of being in an industry that manufactures devices or products containing energy. Our batteries contain potentially hazardous materials, which could expose us to liability. The raising of any health or safety issues could impact our reputation and sales. Moreover, changes in environmental or other regulations affecting the manufacture, transportation or sale of our products could adversely affect our ability to manufacture or sell our products or result in increased costs or liability. Finally, we may be required to devote significant financial and management resources to processing and remedying warranty claims. If product liability issues arise, we could incur significant expenses and suffer damage to our reputation and the market acceptance of our products.

To mitigate these risks of product liability, we undertake extensive internal and external product and safety testing. Unlike certain competing technologies, our products do not contain cadmium or lithium metal, which are considered hazardous materials for purposes of disposal or transportation. We believe that there are currently no regulations in North America that would prevent us from the manufacture, sale or transportation of our batteries, and we are fully committed to ensuring our products are environmentally friendly. In certain situations or applications, battery power may be a more attractive environmental solution than other energy sources utilizing fossil fuels or creating emissions.

We may not be able to successfully market our battery technology and products, and because our SuperPolymer technology is entirely new, our batteries may not perform as well as we anticipate. We expect to sell our products directly to corporate customers and through value-added resellers and distributors. But if these parties do not purchase our products or purchase them in lower quantities or over longer time periods than we expect, our revenue profile and cash flows may be severely impacted. Initially we expect to rely upon a limited number of customers for a significant portion of our sales and the loss of any customer could have a material adverse effect on our sales and operating results, and make it more difficult to attract and retain other customers.

Our PowerPad 160 product has undergone extensive user testing. We have now sold limited quantities of our products to well established corporate users with positive early results. We have an aggressive marketing program in place, including trade shows, advertising, etc. We have recently hired a dedicated sales team to aggressively market and sell our products. We are adopting a multi-channel distribution strategy to reduce our reliance on a single customer or distributor. We are targeting different types of users, applications, and industries to mitigate the risk if our products do not achieve acceptance in a single market and to ensure we minimize reliance on one customer.

If we fail to manage growth successfully, we could experience delays, cost overruns or other problems. Similarly, if we are unable to hire or retain qualified, key personnel, our business may be jeopardized.

We have identified and are acting on the need to hire additional staff for our manufacturing facility, at the senior management levels and for specialized personnel in various disciplines or areas of expertise, to help ensure the Company continues to effectively manage its rapid growth as it moves to a multi-plant operation. Additionally, our senior management team has significant breadth and depth of expertise in managing startup situations, which will assist the Company in making the transition from a small private company to a large public company. To assist us in attracting and retaining key personnel, we are currently implementing a competitive market driven compensation structure.

If we fail to protect our proprietary technology, we may lose any competitive advantage it provides. Others may claim that our products infringe on their intellectual property rights, which could result in significant expenses for litigation, developing new technology or licensing existing technologies from third parties. In addition, if we are unable to register our trademarks, or our trademarks or trade name are found to violate the rights of others, we may have to change our trademarks or name and lose the goodwill we have created in them. A proceeding was instituted against us on August 1, 2000 in the United States District Court in respect of our name Electrofuel. If we are unsuccessful in defending this proceeding we will be required to change our corporate name and to cease using Electrofuel or any variations as trademarks.

We will continue to register patents resulting from ongoing research and development activity, acquire or license patents from third parties if appropriate and further develop the trade secrets related to our manufacturing process and the design and operation of the equipment used to manufacture our products.

❖❖❖ **OUTLOOK**

Our goal is to make our proprietary SuperPolymer technology the industry standard in portable power. Our strategy to achieve that goal includes:

- Quickly penetrating the portable computer market and establish a presence in the mobile phone battery market.
- Developing brand recognition.
- Developing new alternative power applications for our SuperPolymer technology.
- Forming strategic alliances in alternative power industries.
- Continuing to enhance our technological leadership and product differentiation through continued investment in research and development.

To date, we have developed our technology, financed our expansion, pre-marketed certain of our products, purchased machine-making equipment and acquired a manufacturing facility. When our high-volume facility comes onstream in the second quarter of 2001, we expect to start generating revenue from commercial production. We believe the output of this facility will be taken up quickly as the performance and value of our products become known in our target markets. We are therefore confident that the risks inherent in our business and markets are mitigated by our technology, the quality of our products, and the capabilities of our management and staff.