The company is well-positioned to
accelerate its top-line growth,
with sufficient cash resources
and **no debt** on its books.

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Vice president, finance & chief financial officer

M D & A

The following discussion and analysis of Electrofuel Inc.'s ("Electrofuel" or the "Company") financial condition and results of operations for the fiscal years ended September 30, 2001 and 2000 should be read in conjunction with the Company's financial statements and related notes. Electrofuel's financial statements are presented in thousands of U.S. dollars. Electrofuel prepares its financial statements in accordance with Canadian generally accepted accounting principles. This year, the Company transitioned from a late-stage development company to an early-stage commercial manufacturer.

This Annual Report may contain 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 Risks and Uncertainties section of Management's Discussion and Analysis provided below, and 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.

The Company plans to change its name to Electrovaya Inc., pending shareholder approval at the annual and special meeting to be held in Toronto, Ontario on March 26, 2002. The decision to change the name resulted from the settlement of a legal proceeding in which the plaintiff claimed that the Company's use of the name "Electrofuel" constituted an infringement of its registered trademark. No compensation was paid to the plaintiff.

Business of the Company

Electrofuel has developed a proprietary advanced alternative power technology, which has a broad spectrum of potential applications. This technology is called "SuperPolymer™" and it enables production of portable rechargeable batteries that have significantly longer run-times for their size and weight than any rechargeable batteries currently in commercial production.

Electrofuel was founded in September 1996 by Dr. Sankar Das Gupta and Dr. James K. Jacobs. They incorporated The Electrofuel Manufacturing Company Ltd. ("Electrofuel Manufacturing") to undertake a variety of technology development projects, including a lithium ion battery development project. 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. In October 1996, Electrofuel acquired patents and patent applications with respect to the rechargeable lithium ion polymer battery technology from Drs. Das Gupta and Jacobs. In January 1997, it acquired all assets relating to the lithium ion polymer battery technology from Electrofuel Manufacturing.

In January 1997, Electrofuel completed a private placement in Canada and used the net proceeds of $6.5 million from the offering to continue the development of its lithium ion battery technology, develop products that utilize this battery technology, improve its research and development, establish a low-volume production facility and fund operations. In June 1999, the Company introduced its first commercial product, the PowerPad 160, a rechargeable lithium ion polymer battery designed for external use with portable computers. In February 2000, at the Wireless 2000 trade show, it exhibited its prototype EF2100 mobile telephone battery which, based on internal testing, is compatible with Nokia 5100, 6100 and 7100 series mobile telephones. The Company is beginning commercial production of this product.

In January 2000, Electrofuel raised net proceeds of $28.4 million through the private placement of special warrants in Canada, the United States and abroad. These proceeds were used, in part, to acquire and equip its manufacturing facility in Mississauga, Ontario, which became operational in the third fiscal quarter of 2001. This facility will have a monthly production capacity of approximately five million watt hours, which is equivalent to approximately 30,000 PowerPad 160 units.

In February 2000, the Company acquired machinery and equipment from an industrial machine-building company in the Toronto area for $1.1 million to provide it with the internal capability to manufacture the proprietary equipment it requires to make its products. In April 2000, Electrofuel acquired a site for $2.6 million and built the equipment for its Mississauga manufacturing facility.

In November 2000, Electrofuel completed a public offering of 6,250,000 common shares providing net proceeds of $28.2 million. Some of the proceeds will be applied to an expansion of the Mississauga facility to enable a monthly production capacity of approximately 10 million watt hours, which is equivalent to approximately 60,000 PowerPad 160 units. The balance of the proceeds will be used for general business development, to fund working capital needs and to finance operations.

During the fiscal year ended September 30, 2001, the Company added engineering and production staff and filled key senior management positions. It introduced the PowerPad 120, a product with a run time of up to 12 hours that will serve as a complement to the PowerPad 160 for those users requiring shorter run times. Its employee base increased significantly during this period to 175 staff from 74 at September 30, 2000. It expects further increases in personnel during the next 12 months as it increases commercial production of the PowerPad 120 and 160 models and the EF2100, and continues to develop and expand its product offering.

Results of Operations

Years ended September 30, 2001 and September 30, 2000

Revenue

Revenue increased to $1.0 million for the year ended September 30, 2001 from $152,000 for the year ended September 30, 2000. The sales of PowerPad 120 and 160 products to corporate customers, distributors, and individuals represent the beginning of the production ramp-up at the Company's new Mississauga facility. Electrofuel recognizes revenue on the sale of commercial products at the time the units are shipped to customers net of a provision for returned units.

Expenses

Start-up and Manufacturing. All of the material and labor costs and related manufacturing overhead associated with the production of commercial products and the start-up costs of the plant have been charged to start-up and manufacturing expenses. These expenses amounted to $3.9 million in fiscal 2001. There was no comparable expense category in the prior year as commercial production commenced in April 2001. Included in start-up and manufacturing expense was $0.8 million for building and production equipment amortization for the period from commencement of production to the year-end.

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 to $2.1 million for the year ended September 30, 2001 from $1.0 million for fiscal 2000. This increase in net research and development expenses reflects the increased research and development efforts to improve production methodology, improve technology and enhance and develop new products.

Sales and Marketing. Sales and marketing expenses increased to $1.6 million for fiscal 2001 from $0.8 million for the year ended September 30, 2000. The Company enhanced its sales and marketing team significantly. It also increased its activity in marketing, trade shows, advertising and other costs associated with sales of the PowerPad product line. Electrofuel has also increased the overall awareness of its products and technology.

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. The Company's corporate administrative staff includes its executive officers and employees engaged in business development, financial planning and control, legal affairs, human resources and information technology.

General and administrative expenses increased to $3.0 million for the year ended September 30, 2001 from $1.9 million for fiscal 2000. This increase reflects the repurchase of stock options of a senior officer who left the Company and increases in corporate staff, legal and consulting fees and amortization expense.

Other Income

Other income was derived primarily from the provision of consulting, development and engineering support services to third parties net of related expenses. Other income decreased to $57,000 for the year ended September 30, 2001 from $130,000 for fiscal 2000.

Interest Income

Interest income increased to $1.9 million for the year ended September 30, 2001 from $1.1 million for the year ended September 30, 2000. The Company derived interest in both periods from cash and short-term investments. The increase primarily reflects the additional interest derived from the unused portion of the proceeds from the Company's January 2000 special warrant financing and the November 2000 public offering of shares.

Foreign Exchange Gain

The foreign exchange gain decreased to $0.5 million in fiscal 2001 from $0.9 million in fiscal 2000. This change was due primarily to the US dollar increasing in value relative to the Canadian dollar. The exchange rate on September 30, 2001 was $1.5797 and on September 30, 2000 was $1.5070.

Liquidity and Capital Resources

Since inception, Electrofuel has financed its operations primarily through private and public placements of its securities. As of September 30, 2001, it had raised aggregate net proceeds of $63.7 million and had $30.7 million in cash, cash equivalents and short-term investments.

Cash used in operating activities was $8.3 million for the year ended September 30, 2001 and $0.4 million for fiscal 2000. Net cash used in operating activities for fiscal 2001 reflects the operating loss of $7.2 million offset by amortization of $1.5 million and an increase in non-cash operating working capital of $2.6 million. The increase in non-cash working capital was principally attributable to an increase in inventory of $1.8 million and a decrease in accounts payable and accrued liabilities of $0.7 million.

Cash provided by financing activities was $30.2 million for the year ended September 30, 2001, compared to $26.1 million for fiscal 2000. These financing activities consisted primarily of the public offering of shares of $30.0 million in November 2000 and a private placement of the Company's securities amounting to $28.4 million in January 2000.

Cash used in investing activities was $24.5 million for the year ended September 30, 2001 compared with $20.9 million for fiscal 2000. Cash used in investing activities reflects $9.2 million of spending on building improvements and machinery and equipment for the Mississauga plant and $15.3 million of net additions to short-term securities. Capital expenditures constituted 55% of the total cash consumption for the year.

Electrofuel has recorded net losses in every year since its inception. As it continues to make investments in product development and marketing activities, it expects to incur net losses at least through the fiscal year ending September 30, 2002. In the current and future quarters, the Company expects increases in expenses in all categories. It expects research and development expenses to increase as it continues to develop its mobile telephone battery product lines and explore other potential applications for its technology. Electrofuel also expects its sales and marketing expenses to increase as it rolls out a marketing programme with an extensive advertising component. General and administrative expenses are anticipated to increase moderately as the Company increases its corporate infrastructure to support the growth of its business in anticipation of high-volume production. Additional costs will be incurred for a new enterprise resource planning and management information system. It currently plans to fund these expenses with cash on hand.

Electrofuel has not yet received significant revenue from the sale of its batteries. Since April 2000, it has sold limited quantities of the PowerPad 120 and 160. As it continues to ramp up to larger scale commercial production of its PowerPad products, it expects that its principal source of revenue will be the sale of these battery products. Initially, the Company expects that its sales will be concentrated among a limited number of distributors, value-added resellers and catalogue houses. Eventually, it expects to enter into agreements with original equipment manufacturers ("OEMs"). Such agreements would involve the joint marketing and bundling of its products with those of the manufacturer.

Electrofuel expects to continue to experience negative cash flow in the foreseeable future. It expects that its capital expenditures will decrease significantly in the future as it has substantially completed the expansion of its Mississauga manufacturing capacity. It will begin to disclose cost of sales in its next fiscal year as revenues and related manufacturing costs increase.

Future liquidity and capital requirements will depend principally on the rate of growth and the means by which the Company achieves its growth. The Company believes that the cash on hand will be sufficient to meet its requirements until at least September 2003. It believes that it may be able to adjust the timing and extent of capital investment if additional capital is not available to it. Its capital needs in future periods will depend principally on its ability to generate sales of its products, the extent and timing of future increases in manufacturing capacity and the extent to which it engages in acquisitions and joint ventures.

Recent Accounting Pronouncements

The Canadian Institute of Chartered Accountants has issued new accounting standards for "Earnings per share", which are effective for the Company's fiscal 2002 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, Electrofuel's basic loss per share is unaffected and its options are anti-dilutive.

Qualitative and Quantitative Disclosures about Risks and Uncertainties

Interest Rate Risk

As of September 30, 2001, the Company had cash and short-term investments totaling $30.7 million, which consisted of cash and cash equivalents of $2.4 million, including investments with original maturities of two months or less at the date of purchase and $28.3 million of short-term commercial paper with maturity of 127 days at the time of acquisition. These securities bear interest at a weighted average rate of 5.25%. As a result of their short-term maturities, the Company does not believe these investments are subject to significant interest rate risk. Recent declines in short-term interest rates will, however, significantly reduce the interest income earned in 2002 on these investments.

Foreign Currency Exchange Rate Risk

In the year ended September 30, 2001, over 90% of the Company's revenue was derived from US customers in US dollars. The Company expects that the majority of its sales will, in the future, be made in US dollars and that in the short term, the majority of its expenses will be denominated in Canadian dollars. As of September 30, 2001, $7.7 million of cash, cash equivalents and short-term investments were denominated in US dollars. Fluctuations in the exchange rate between the Canadian dollar and the US dollar may therefore have a material effect on results of operations. The Company does not currently engage in currency hedging activities.

Credit Risk

The Company manages its credit risk with respect to accounts receivable by establishing and implementing credit limits and approval policies, as well as dealing primarily with large creditworthy customers. It has insured all of its accounts receivable with the Export Development Corporation to the extent of 90% of coverage.

Other Risks and Uncertainties

Electrofuel is an early-stage commercial company facing corresponding risks, expenses and difficulties that may affect its outlook and eventual results of its business and commercialization plan.

Electrofuel may not be able to establish high-volume production on a timely, cost-effective basis or at all. It has never manufactured batteries in large quantities and it may not be able to maintain future commercial production at planned levels. Additionally, if it is unable to secure an adequate supply of raw materials or components, its costs could increase or its production could be limited.

Electrofuel is taking a number of steps to offset these risks:

- Its manufacturing process is modular and flexible.
- Its high-volume facility utilizes machinery and equipment that is similar to the machinery and equipment that it has already designed, built and used in its pilot production plant. Since the introduction of its PowerPad in 1999 it has successfully produced finished products in its pilot and commercial plants, resulting in sales.
- It is 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.
- It intends to ensure it has more than one supplier for critical raw materials and components.

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

Electrofuel has addressed these risks by designing and building its high-volume facility with worker safety in mind. In addition, it has adopted a formal environmental policy that requires compliance with environmental legislation and an ongoing program of monitoring its environmental compliance.

Electrofuel does not have a collaborative partner to assist it in the development of its batteries, which may limit its ability to develop and commercialize its products on a timely basis. Furthermore, it may incur significant costs and invest considerable resources designing and testing batteries for use with, or incorporation into, specific products without significant return.

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

Electrofuel may not be able to compete effectively with other manufacturers of compact recharge-able batteries. There is also the possibility its competitors may develop portable power technologies that match or outperform the SuperPolymer™ technology, which may diminish the demand for the Company's products. In addition, innovations in the design of portable computers, mobile telephones and other wireless devices may reduce the need for its batteries.

The market for rechargeable batteries is competitive and fragmented. Electrofuel believes it is well positioned to compete in the market for compact rechargeable batteries, which is already very large and growing rapidly. The adoption rate of lithium ion batteries is 35% per year as the nickel cadmium and nickel-metal hydride technology sectors decline. There are currently five to seven principal competitors, primarily well capitalized companies based in Japan, which have in aggregate a dominant market position in the lithium ion and lithium ion polymer battery sector. By leveraging the Company's technological advantage, moving quickly to penetrate the market, initially targeting the underserved aftermarket, and emphasizing its higher energy density to create brand differentiation, Electrofuel expects to increase revenue in the near term. Additionally, the Company believes 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. Finally, miniature fuel cells present potential future competition to batteries in the portable and mobile power applications. However, they are expensive and still have technical hurdles to overcome, thus mitigating the threat to Electrofuel's products in the electronics markets that it targets.

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

Electrofuel is exposed to certain risks as a result of being in an industry that manufactures devices or products containing energy. All lithium ion polymer batteries can become hazardous under some circumstances. In the event of a short circuit or other physical, electrical or thermal damage to these batteries, chemical reactions may occur that release excess heat or gases, which could create dangerous situations, including fire, explosions and releases of toxic fumes. The Company's batteries may emit smoke, catch fire or emit gas, any of which may expose Electrofuel to product liability litigation. In addition, these batteries incorporate potentially hazardous materials, which may require special handling, and safety problems may develop in the future. Product failure or improper use of lithium ion polymer battery products, such as the improper management of the charging/discharging system, may also result in dangerous situations. The raising of any health or safety issues could affect the Company's reputation and sales. Moreover, changes in environmental or other regulations affecting the manufacture, transportation or sale of Electrofuel's products could adversely affect the Company's ability to manufacture or sell its products or result in increased costs or liability. Finally, Electrofuel may be required to devote significant financial and management resources to processing and remedying warranty claims. If product liability issues arise, the Company could incur significant expenses and suffer damage to its reputation and the market acceptance of its products.

To mitigate these risks of product liability, Electrofuel undertakes extensive internal and external product and safety testing. Unlike certain competing technologies, its products do not contain cadmium or lithium metal, which are considered hazardous materials for purposes of disposal or transportation.

The Company believes that there are currently no regulations in North America that would prevent it from the manufacture or sale of its batteries, and Electrofuel is fully committed to ensuring its products are environmentally friendly. It is currently examining the impact of the recent international regulation of air transportation of lithium ion batteries and expects to be in compliance shortly. In certain situations or applications, battery power may be a more attractive environmental solution than other energy sources utilizing fossil fuels or creating emissions.

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

The PowerPad 120 and 160 products have undergone extensive user testing and have now been sold in limited quantities to well-established corporate users, distributors and value-added resellers with positive early results. Electrofuel has an aggressive marketing program in place, including trade show participation and advertising campaigns. The Company has hired a dedicated sales team to aggressively market and sell its products in the United States and Canada. Electrofuel is adopting a multi-channel distribution strategy to reduce its reliance on a single customer or distributor. The Company is targeting different types of users, applications and industries to mitigate the risk if its products do not achieve acceptance in a single market and to minimize reliance on one customer.

If the Company fails to manage growth successfully, it could experience delays, cost overruns or other problems. Similarly, if it is unable to hire or retain qualified, key personnel, its business may be jeopardized.

Electrofuel has identified and is acting on the need to hire additional staff for its 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, its senior management team has significant breadth and depth of expertise in managing start-up situations, which will assist the Company in making a smooth transition from a small private company to a large public company. It has implemented a market-driven compensation structure and benefits plan to assist it in attracting and retaining key personnel.

If Electrofuel fails to protect its proprietary technology, it may lose any competitive advantage it provides. Others may claim that the Company's 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. If Electrofuel is unable to register its trademarks, or if its trademarks or trade name are found to violate the rights of others, the Company may have to change its trademarks or name and lose the goodwill created in them.

Electrofuel 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 its manufacturing process and the design and operation of the equipment used to manufacture its products.

Outlook

Electrofuel is well positioned to meet the growing demand for mobility and productivity from portable computer users. The Company has a cluster of unique products to meet this demand and has successfully commissioned the Mississauga manufacturing plant. Electrofuel is rapidly opening up distribution channels to meet the challenge of the global market for mobile energy.

The Company's primary objective is to achieve profitability through a combination of increasing revenue and controlling costs. It will further support sales through the appointment of additional major distribution channels in North America and by partnering with OEMs. Concurrently, it is focussing its research and development on expanding its markets through the development of new products.

While overall information technology spending has declined with the economic slowdown, the cell phone market remains strong. In the laptop market Electrofuel is seeing an increasing demand for batteries with maximum runtime as corporations are meeting the needs of a mobile workforce and extending the life of older laptops. While the Company will benefit most from a strong economy, its high-energy -density battery applications are also well suited for today's environment. Electrofuel is well positioned to meet the vigorous demands for increased mobility and productivity in the global economy.