

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

## Introduction

Management's discussion and analysis (MD&A) provides our viewpoint on our Company, performance and strategy. "We," "us," "our," "Company" and ElectroVaya include ElectroVaya Inc. and its wholly-owned subsidiaries.

Our Board of Directors, on the recommendation of its Audit Committee, approved the content of this MD&A on August 12, 2006 and it is, therefore, dated as at that date. This MD&A includes the operating and financial results for the quarter ending June 30, 2006 and 2005, and should be read in conjunction with our Consolidated Financial Statements. It includes comments that we believe are relevant to an assessment of and understanding of the Company's consolidated results of operations and financial condition. The financial information herein is presented in thousands of US dollars unless otherwise noted, in accordance with Canadian generally accepted accounting principles. Additional information about the Company, including ElectroVaya's current annual information form, can be found on the SEDAR website for Canadian regulatory filings at [www.sedar.com](http://www.sedar.com).

## Forward-looking statements

This MD&A 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 risks and uncertainties include, without limitation, the various factors set forth in the Risks and Uncertainties section of the MD&A provided below, and are also discussed in public disclosure documents filed with Canadian regulatory authorities. No assurance can be given that results, performance or achievement expressed in, or implied by, forward-looking statements within this disclosure will occur, or if they do, that any benefits may be derived from them. ElectroVaya disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## Our Company

ElectroVaya has been in business since 1996 and became listed on the Toronto Stock Exchange under the ticker symbol "EFL" in November 2000. By 2002, we began commercializing our Lithium Ion SuperPolymer ® technology.

Our main businesses include:

1. Lithium Ion SuperPolymer ® batteries such as showcased in our PowerPad ® 80, 120, 160 and 300 batteries for the notebook market.
2. Scribbler ® Tablet PCs, including our third generation SC 3000 series, for those laptop computer companies that require a mobile solution, with a tablet that provides long battery life.
3. Aerospace and defence, such as power solutions for NASA and others, including competencies in building machines for third parties.
4. Electric vehicles, whereby we are developing our power-system designs for clean transportation applications.

### **Core Capabilities**

In addition to developing and acquiring approximately 175 patents and patent applications with respect to rechargeable Lithium Ion SuperPolymer ® battery technology, we have approximately 150,000 square feet of manufacturing and research and development facilities capable of producing Lithium Ion SuperPolymer ® materials and battery systems for numerous industries.

Electrovaya continues to spend heavily on research and development, with approximately 82% of revenue being reinvested in research and development activities in the quarter ending June 30, 2006.

Electrovaya also has a team of mechanical, electronic, battery and system engineers able to give clients a “complete solution” for their energy and power requirements.

### **Our Strategy**

Our long-term success is measured by our success in building new strategic partnerships, new product creation, improved distribution channels, and enhanced technology development. Through these initiatives, our objective is to achieve significant growth in revenue, profitability and cash flow.

The Company’s strategic plan involves the following key elements:

- Establish global, strategic relationships in order to broaden the market potential of Electrovaya’s products and services.
- Establish additional channels to market by creating new relationships with distributors, value-added resellers and independent software vendors for our PowerPad ® , Scribbler ® and mobile computing products.

- Further automate production processes to lower product costs and increase quality by using best practices manufacturing approaches and through continuous improvement initiatives.
- Invest in research and development initiatives related to new technologies that reduce the cost, but enhance the operating performance, of our current and future products.
- Develop new products that use Electrovaya high energy density batteries to give a competitive advantage.
- Develop and commercialize leading-edge technology for zero-emission vehicles, including electric drive trains and partnering with key large organizations to bring them to market.

## **Marketing and Sales**

The market for rechargeable batteries is competitive. To compete successfully, we intend to continue to build on the advantages offered by our technology by adding new strategic partnerships and increasing distribution capabilities through new channels, including new master distributors, Independent Software Vendors (“ISVs”) and Value Added Resellers (“VARs”). In addition, our direct sales team is continuously prospecting new major customers, and programs are underway to increase sales through ecommerce, trade shows and other advertising initiatives.

For the mobile computing business, our focus is on such industry verticals as healthcare, insurance, sales force automation and education. For example, in healthcare, we are attending the majority of related trade shows, increasing advertisements in trade magazines and increasing our focus on partnerships with ISVs, VARs and distributors. We have also been working to obtain favorable product reviews by key individuals able to influence the market.

For electric vehicles, our sales and marketing efforts are based more on building partnerships with key companies and groups and presenting to, and attending, key trade shows and expositions.

For battery and engineering services sales, we are targeting opportunities in the aerospace and military sectors.

Electrovaya’s products include:

- Mobile computing solutions. These consist of the PowerPad ® 80, 120, 160 and 300 series of batteries, a source of power and longer run times for notebook computers and other mobile applications, as well as the Scribbler ® series of Tablet PCs with the longest run-times in the industry. The SC3000 series is the third generation of tablet

PC and has received excellent reviews. It is lightweight, thin and the most mobile tablet in the industry.

- Batteries for aerospace and defence. These products consisted of specialized batteries and chargers for NASA, as well as certain defence industries, and include precision machining of metal, plastics and other materials for specific applications. These products are typically large format and with significant technological sophistication, with some component of research and development with each application.
- Clean transportation. Power systems for electric vehicles and other related applications.

The Company has entered into an agreement with the New York State Energy Research and Development Authority (“NYSERDA”), whereby Electrovaya would develop zero emission lawn and turf off-road equipment and acquire space in the Saratoga Technology + Energy Park (“STEP”) in Malta, New York. In order for Electrovaya to develop systems for the golf and turf industry, NYSERDA provided \$1 million in research and development funds, with additional support from a private-sector company and from the New York State Office for Parks Recreation and Historic Preservation.

### **Research and Development**

We plan to continue to improve all aspects of our battery technology by partnering with key technology partners. This includes work on new positive and negative electrodes and a polymer battery for special high temperature applications. To support the commercialization of these products in a cost-effective manner, we are also developing a high-speed production capability for high-rate and high energy cells.

For those markets where large power systems are required, we are also developing large format cells and battery management systems and high efficiency electronics.

Through continuous improvements to our technology, we intend to continue to improve the energy density of our products, promote such advances into production and achieve a cost structure that enables us to maintain our competitive advantage.

### **Overall Performance and Selected Financial Information**

Unless otherwise indicated, all comparisons to the third quarter of 2006 are to the third quarter of 2005.

Due to a recalculation relating to the prior year foreign currency translation, the September 30, 2004 Capital assets and cumulative translation adjustment comparative amounts were increased by a cumulative amount of \$ 3,003 in the fourth quarter of 2005. This correction had no impact on the Company’s net loss or cash flows for the current or prior years.

During the fourth quarter of fiscal 2005, the Company reviewed the estimated useful life of depreciable assets resulting in a prospective change in amortization for production equipment and building improvements. This resulted in production equipment and building improvements being amortized on a straight line basis over the next 6 and 15 years respectively.

The Company has reported a current-period operating and cash flow loss and has a history of operating and cash flow losses. The recent performance of the Company and its near-term forecast indicated that the carrying amount of the capital assets may not be recoverable in accordance with the accounting standard CICA Handbook Section 3063 "Impairment of Long-Lived Assets."

During the quarter ended March 31, 2006, the Company performed an impairment analysis, which indicated that the estimated undiscounted future cash flows generated by the capital assets were less than their carrying values. The carrying values of the capital assets were reduced to fair market value, with a resulting capital assets write-down of \$4,020. Where possible, management estimated fair market value using third party appraisals.

*Years ended September, 2005, 2004 and 2003*

**i) Financial Condition**

(\$ thousands)	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Cash &amp; Cash Equivalents</b>	12,233	13,612	17,593
<b>Total Assets</b>	25,982	29,686	36,183
<b>Total Long Term Liabilities <sup>(a)</sup></b>	-	-	-
<b>Shareholders' Equity</b>	24,378	28,172	34,417

(a) Potential long-term financial liabilities are described below (See **Financial Condition - TPC Contribution Agreement**)

Our cash utilization from 2003 to 2004 was approximately \$4.0 million and from 2004 to 2005 was \$1.4 million.

Cash & Cash Equivalents held in US dollars were approximately \$5.0 million as at September 30, 2005, \$3.6 million as at September 30, 2004, \$4.0 million as at September 30, 2003 and \$5.0 million as at September 30, 2002.

(\$ thousands)	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Revenue</b>	\$ 6,540	\$ 6,369	\$ 4,323
<b>Revenue, Less Direct Manufacturing Costs</b>	1,280	847	(1,008)
<b>Loss Before Interest, Taxes and Amortization</b>	3,771	5,415	6,891
<b>Net Loss</b>	6,322	8,463	9,876
<b>Basic and Diluted Loss per Share</b>	0.09	0.12	0.14

<b>Cash flow from Operating Activities</b>	\$ (3,010)	\$ (4,959)	\$ (6,405)
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The Company has reviewed its operations and determined that it operates in one business segment and has only one reporting unit. The Company develops, manufactures and markets portable power technology products.

Revenue derived from US customers in US dollars, as a percentage of the Company's Revenue, was approximately 81% in 2005, 80% in 2004, 80% in 2003 and 95% in 2002. Revenue has increased during the three year period due to the addition of new products (e.g.: December 2002–Scribbler ® Tablet PC, October 2002–PowerPad ® 80, June 2005 -PowerPad ® 300 ) and increased service revenues in 2004 & 2005 from NASA and from the Canadian Space Agency in 2005.

For the years ended September 30, 2005, 2004 and 2003, revenues from major business activities were as follows:

	2005	2004	2003
Services	\$2,211	\$ 1,357	10
Consumer electronics	4,131	4,481	3,774
Other	198	531	539
	\$ 6,540	\$ 6,369	\$ 4,323

For the years ended September 30, 2005, 2004 and 2003, revenues attributed to regions based on location of customer were as follows:

	2005	2004	2003
Canada	\$ 1,200	\$ 962	1,026
United States & Others	5,340	5,407	3,297
	\$ 6,540	\$ 6,369	4,323

The fluctuation in exchange rates has resulted in an increase in labour and manufacturing overhead production costs and other expenses, as these expenses are in Canadian dollars.

Losses have declined as the Company added more profitable product lines (e.g: Scribbler ®) and increased the amount of service revenue. Concurrently, control over manufacturing activities and increased utilization has resulted in improved margins.

Cash used in operating activities has decreased over the three year period due to a reduction in losses and improved working capital management.

The Company has not paid a dividend since inception.

## **Results of Operations**

### *Use of Estimates*

In preparing the financial statements in conformity with generally accepted accounting principles, management makes estimates and assumptions that affect the reported amounts of sales returns, bad debt reserves and warranty accruals at the date of the financial statements.

The Company's existing policy allows for sales returns ranging from 15 days for direct sales to end users to longer periods for sales to key distributors. Sales returns are estimated at the time of delivery based on past experience and customer specific factors. Each quarter, a provision for sales returns is determined based on the actual experience for the most recent four prior quarters. Sales returns are applied against revenue for the Scribbler® and PowerPad® products, and represented approximately 5.9% of revenue from consumer electronics for the quarter ended June 30, 2006.

The Company reviews its outstanding accounts receivable on a regular basis. Bad debts are determined based on the ageing of accounts receivable where such amounts are not insured and considered uncollectible.

Warranty accruals are based on the actual warranty experience rate for the past year for each product group and sales during the most recent warranty period. These amounts are reviewed quarterly and included in sales and marketing expenses. Warranty provisions represented approximately 9.7% of consumer electronic sales for the quarter ended June 30, 2006.

### *Revenue*

Revenues are derived from the sale of PowerPad® and Scribbler® Tablet PC products, as well as from machines built for third parties, and from services provided for research and development activities.

Revenue from product sales is recognized upon shipment, since persuasive evidence of an arrangement exists, risks and rewards of ownership have been transferred to customers, selling price is fixed and determinable, and collectibility is reasonably assured. Estimated returns and allowances and sales rebates are recorded as a reduction of revenue at the time of revenue recognition. In addition, the Company provides for the estimated cost of standard product warranties at the time of revenue recognition.

The Company primarily uses a binding purchase order as evidence of its product sales arrangements and, with respect to its service arrangements, uses contractual agreements. The Company considers delivery to occur upon shipment, provided risks and rewards of

ownership, including transfer of title, have passed to the customer. At the point of sale, the Company assesses whether collection is reasonably assured. If the Company determines that collection is not reasonably assured, the Company defers recognition of the revenue until collection becomes reasonably assured, which is generally upon receipt of cash. Where an estimate of the potential sales returns cannot be made, the recognition of revenue does not occur until the distributor has sold the product.

Revenue from services provided to third parties under contracts is recognized as services are performed and as each milestone in the contract is achieved and accepted by the customer.

Revenue from custom machine-building is recognized on a percentage of completion method of accounting for contracts. Under such contracts, revenue is recognized based on the ratio of total costs incurred to date to overall estimated costs. Provisions for estimated losses on contracts are recognized when identified.

For the three month period ended June 30, 2006, total revenue decreased by 8.6% to \$1.0 million from \$1.1 million for the quarter ended June 30, 2005. The decrease in total revenue primarily resulted from a reduction in consumer electronics revenue.

For the nine month period ended June 30, 2006, total revenue declined by 35.0% or \$1.3 million from \$3.8 million to \$2.4 million primarily due to lower consumer electronics revenue.

Quarterly and year-to-date revenue is as follows:

(\$ thousands)	<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>
2006	\$ 588	855	1,002	N/A
2005	1,488	\$1,180	\$ 1,096	\$ 2,776
2004	1,581	1,593	1,559	1,636
2003	883	1,364	778	1,298

Continued advances in technology and a highly competitive market are more significant factors than general inflationary conditions and specific price changes when considering major impacts on revenue.

Management is not aware of any seasonal fluctuations in revenue.

#### *Expenses*

*Direct Manufacturing Costs and Revenue, less Direct Manufacturing Costs.* *Direct Manufacturing Costs* are comprised of the material, labour and manufacturing overhead, excluding amortization, associated with the production of SuperPolymer<sup>®</sup> batteries and the Scribbler<sup>®</sup> Tablet PC, machine building for third parties and research service revenues.



For the quarter ended June 30, 2006, direct manufacturing costs increased by 11.1% or \$94 to \$944 from \$850 for the quarter ended June 30, 2005 due to negative production variances as production process changes were made to improve future efficiencies.

For the nine months ending June 30, 2006, direct manufacturing costs decreased by 28.6% or \$969 to \$2.4 million from \$3.4 million for the quarter ended June 30, 2005. This was primarily a result of lower material costs related to lower sales and lower manufacturing labour costs as more time was spent on research and development activities.

*Revenue less Direct Manufacturing Costs* was a profit of \$58 for the three months ended June 30, 2006, compared to a profit of \$246 or 22.4% of revenue for the three months ended June 30, 2005.

For the nine months, *Revenue less Direct Manufacturing Costs* was a profit of \$20 compared to a profit of \$370 during the same period the prior year. In the prior year, the Company benefited from the more profitable service revenue.

*Research and Development.* Research and development expenses consist primarily of compensation for research and development personnel and proportionate premises cost for research and development activities, including independent contractors and consultants, direct materials and allocated overhead.

Research and development expenses, net of investment tax credits, increased by \$21 or 2.6% to \$818 for the quarter ended June 30, 2006 from \$797 for the same three month period in 2005 due primarily to an increase in labor & material and subcontract expenses. During the three month period ended June 30, 2006, the Company received \$197 of cash contributions from Technology Partnerships Canada (TPC), compared to \$407 during the three months ended June 30, 2005.

Compared to the nine month period ending June 30, 2005, research and development expenses increased by \$541 or 29.5% from \$1.8 million to \$2.4 million during the nine month period ending June 30, 2006. The Company attempts to redeploy resources wherever possible if these resources are not required for manufacturing activities, resulting in increased labour and material expenses compared to the same period the prior year.

*Sales and Marketing.* Sales and marketing expenses are comprised of the salaries and benefits of sales and marketing personnel, marketing activities, warranty provisions, advertising and other costs associated with the sales of the PowerPad® and Scribbler® product lines.

For the quarters ended June 30, 2006 and 2005, sales and marketing expenses were \$166 and \$276, respectively. The \$110 decrease was primarily due to decreased salaries and trade show attendance costs compared to the same quarter in the prior year.

Compared to the nine month period ending June 30, 2005, sales and marketing expenses decreased by \$393 or 45.1% from \$0.9 million to \$0.5 million during the nine month period ending June 30, 2006 due to lower salaries and benefits, advertising and trade show attendance expenses.

*General and Administrative.* General and administrative expenses include salaries and benefits for corporate personnel, insurance, professional fees, reserves for bad debts and facilities expenses. 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 by 74.6% or \$250, to \$585 for the quarter ended June 30, 2006 compared to \$335 for the same period in the prior year. The increase primarily reflects an increase in salaries and benefits and an increase in the provision for bad debts.

Compared to the nine month period ending June 30, 2005, general and administration expenses of \$1.6 million remained relatively unchanged.

#### *Net Income*

Quarterly net losses are as follows:

(\$ thousands)	<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>
2006	\$ 1,193	\$ 5,462	805	N/A
2005	1,952	\$ 2,360	\$ 1,210	\$ 800
2004	2,402	1,861	2,085	\$ 2,115
2003	2,901	2,379	3,121	1,475

Quarterly net losses per share are as follows:

	<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>
2006	\$ 0.02	\$ 0.08	0.01	N/A
2005	0.03	0.03	\$ 0.02	\$ 0.01
2004	0.03	0.03	0.03	0.03
2003	0.04	0.03	0.04	0.02

During the quarter ending September 30, 2005, a wholly owned subsidiary was amalgamated with another company subject to common control. See "Transactions with Related Parties" on page 13 for additional details.

## Liquidity and Capital Resources

As of June 30, 2006, the Company had \$10.3 million in cash, cash equivalents, and short-term investments compared to \$10.4 million as at March 31, 2006.

Fund flow from operations was a utilization of \$1.6 million of cash for the quarter ended June 30, 2006 compared to a utilization of \$0.9 million for the quarter ended March 31, 2006. Net funds used in operating activities during the third quarter of fiscal 2006 reflects the operating loss of \$0.8 million offset by amortization of \$0.2 million, a decrease in non-cash operating working capital of \$0.2 million, gain on sale of investments by \$0.89 and a \$0.01 million increase in stock compensation expense.

The Company's future minimum lease payments under operating leases for the years ended September 30 are as follows:

2006	\$ 13
2007	12
2008	<u>11</u>
Total	\$ <u>36</u>

There were no material changes in specified contractual commitments during the quarter.

The Company is currently reviewing its requirements for additional capital resources and no commitments exist at the present time.

The authorized and issued capital stock of the Company consists of an unlimited number of Common shares as follows:

	Number	Amount ( US \$ '000)
Balance, September 30, 2002 & 2003	69,539,109	63,729
Stock options exercised	36,333	16
Balance, September 30, 2004, 2005 and June 30, 2006	69,575,442	\$ 63,745

The following table reflects the number of options outstanding as at December 31, 2003, December 31, 2004, March 31, 2005, June 30, 2005, September 30, 2005, December 31, 2005, March 31, 2006 & June 30, 2006:

Outstanding, December 31, 2003	1,594,933
Granted	475,000
Cancelled or expired	(32,666)
Exercised	(36,333)
Outstanding, December 31, 2004	2,000,934
Granted	493,000
Cancelled or expired	(5,000)
Outstanding, December 31, 2004	2,488,934
Cancelled or expired	(20,000)
Outstanding, March 31, 2005	2,468,934
Cancelled or expired	(24,997)
Outstanding, June 30, 2005	2,443,937
Granted	260,000
Outstanding, September 30, 2005	2,703,937
Granted	685,000
Cancelled or expired	
Outstanding, December 31, 2005	3,388,937
Cancelled or expired	10,000
Outstanding, March 31, 2006	3,378,937
Cancelled or expired	179,666
Outstanding, June 30, 2006	3,199,271

### Transactions with Related Parties

1. Electrovaya in previous years invested \$115 in a private unrelated company. In return for its investment, the Company received 6% of the Class A and 21% of the Class B shares of this private company. Additionally, during the previous years, Electrovaya had provided research and development services totaling \$153 to this private company, and received an additional 30% of the outstanding non-voting, participating Class B shares as consideration for the services rendered. The Class B shares were convertible into Class A voting, participating shares in the event the private company became registered on a stock exchange. During the previous years, Electrovaya provided a \$38 loan and space at no additional charge to the private company to assist with the operation of a pilot plant, resulting in the potential for Electrovaya to exert significant influence over the activities of the private company. The private company was owned by arm's length private investors and had not yet reached commercial levels of production. The private company was seeking additional funding and, in the event these efforts were unsuccessful, would have not been a going concern. As a result, the original investment, additional shares and loan were valued at NIL as at September 30, 2005. On April 24, 2006, the Company sold its class A and B shares of the private company to a third party and recorded a gain of \$887 on its sale.

2. In August 2005, the Company purchased all of the issued and outstanding shares of 1020204 Ontario Limited ("102") from its two principal shareholders, Dr. Sankar Das Gupta, who is a director and officer of the Company and Dr. James Jacobs who was an officer of the Company. Electrovaya Inc. then transferred all of its shares in Electrovaya Corp. to 102 in exchange for shares of 102. 102 and Electrovaya Corp. then completed a statutory vertical amalgamation and continued as Electrovaya Corp. (the "amalgamation transaction").

The amalgamation transaction had been accounted for based on CICA Handbook Section 3840, *Related Party Transactions* at the exchange amounts of the assets and liabilities transferred as there has been a substantive change in the ultimate unrelated parties' ownership interests in the subsidiaries. Further the Company had obtained independent evidence on the exchange amounts involved in the amalgamation transaction. An independent committee of the Board was constituted to review the amalgamation transaction. Upon amalgamation, the Company received \$509 of cash and assumed a liability of \$77 relating to interest payable on an income taxes liability of 102. The offset to the \$432 of net assets assumed had been recorded as a credit to income tax recovery in the statement of operations for the fiscal year ended September 30, 2005.

In addition, as at September 30, 2005, Electrovaya Corp carried back income tax losses of \$4,787, eliminating a \$1,148 income tax liability of 102. This transaction had no impact on the statement of operations as a full valuation allowance had been recorded against the income tax losses.

During the previous quarter, it was determined that 102 may have an additional liability to pay an Ontario "corporate minimum tax" of approximately \$343. Pursuant to the terms of the share purchase agreement among Electrovaya, the shareholders of 102 and the principals thereof, Electrovaya had provided notice of its claim for an indemnity in respect of the full amount of this tax liability and consequently this liability had not been recorded in the financial statements.

During the quarter, 102 was served with a Statement of Claim ("Claim") by the purchaser of the land and building at Hanna Avenue, seeking damages in the amount of \$857. The Company is indemnified for such matters under the terms of the purchase and sale agreement mentioned above. Management believes that it is too early to determine the ultimate outcome of these proceedings. However they believe that this claim is without merit.

3. During the quarter ended June 30, 2006, the Company paid \$ 41 (2005 - \$36) to a director of a wholly owned subsidiary company for services rendered to the Company in his capacity as an executive officer.

## **Financial Condition**

**Current Assets.** Cash and cash equivalents consist of investments with maturities of less than 90 days. Short-term investments include banker acceptances, commercial paper and term deposits with maturities of up to 90 days. Inventories include raw materials, semi-finished and finished goods.

Cash, cash equivalents and short-term investments decreased by \$2 million from September 30, 2005 to June 30, 2006.

**Capital assets.** Approximately \$0.05 million of patent and technology capital assets were acquired during the third quarter of fiscal 2006.

**Current Liabilities.** Accounts payable and accrued liabilities decreased by \$0.4 million to \$1.2 million as at June 30, 2006 compared to September 30, 2005.

**TPC Contribution Agreement.** During the quarter ending June 30, 2006, the Company received contributions totaling \$197 from TPC.

On March 31, 2003 the Company entered into an agreement with the Technology Partnerships Canada (“TPC”) initiative of Industry Canada, whereby TPC agreed to fund up to 29.7% of eligible costs related to the Company’s research and development efforts in high rate batteries, up to a maximum amount of \$6.7 million during the work period beginning in January 2002, and ending by September 2007. Under the terms of the agreement, an amount up to a maximum of \$31.1 million is to be repaid by royalties charged on new revenue created from products developed, commencing in 2007 through to 2013, with payment to be deferred or reduced if certain revenue thresholds are not achieved. During the quarter ended December 31, 2003, the Company received \$1.1 million related to eligible research and development expenses for the period from January 1, 2002 to March 31, 2003. Additional claims for \$0.7 million were received in fiscal 2004. During fiscal year ended September 30, 2005, the Company received a total of \$0.7 million from TPC. During the first and second quarters of fiscal 2006, the Company received \$0.2 million and \$0.5 million of cash contributions from the TPC respectively.

**Share capital.** The authorized and issued capital stock of the Company remained unchanged from December 31, 2005. Of an authorized unlimited number of Common shares, 69,575,442 or \$63.7 million are issued and outstanding.

## **Present Status**

During the quarter ended June 30, 2006, the loss before amortization, interest income and foreign exchange increased by \$559 or 74% compared to the quarter ended June 30, 2005. Our cash position included \$10.3 million of cash and cash equivalents, and our “burn rate” of \$0.2 million was significantly better than the \$1.0 million for the quarter ended March 31, 2006.

## **Recent Accounting Pronouncements**

There were no recent accounting pronouncements that affected the accounting of the Company during the first quarter of 2006.

## **Qualitative and Quantitative Disclosures about Risks and Uncertainties**

### *Interest Rate Risk*

As of June 30, 2006, the Company had cash and cash equivalents totaling \$10.3 million.

### *Foreign Currency Exchange Rate Risk*

In the quarter ended June 30, 2006, approximately 84% of the Company’s revenue was derived from U.S. customers in U.S. dollars. The decrease from prior quarters related to increased sales in Canada as a result of the addition of a new distributor, and the sale of a prototype electric car in Norway. The Company expects that the majority of its sales will, in the future, be made in U.S. dollars and that in the short term, the majority of its expenses will be denominated in Canadian dollars. As of June 30, 2006, \$2.9 million of cash, cash equivalents and short-term investments were denominated in U.S. dollars. Fluctuations in the exchange rate between the Canadian dollar and the U.S. 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 also insured its accounts receivable.

### *Other Risks and Uncertainties*

Electrovaya is an early-stage developmental company with revenues from its commercialization efforts. The Company is facing corresponding risks, expenses and difficulties that may affect its outlook and eventual results of its business and commercialization plan.

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

Electrovaya has taken 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®, it has successfully produced finished products in its pilot and commercial plants, resulting in increasing levels of sales.
- It has formalized 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 has more than one supplier for critical raw materials and components.

*Until the establishment of multiple plants, Electrovaya will be dependent upon the operation of a single manufacturing facility and accidents or other operational problems at this facility, or at neighbouring facilities operated by other businesses, 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.*

Electrovaya's plant has been established in a modular manner in such a way that production may continue in the event of non-catastrophic operational problems. In addition, it has adopted a formal environmental policy that requires compliance with environmental legislation and an ongoing program of monitoring its environmental compliance.

*Electrovaya relies upon manufacturers in Taiwan to produce the Scribbler ® Tablet PC and has no long-term supply contracts with them.*

There are numerous suppliers in Taiwan and throughout Asia capable of producing a tablet PC and it is possible to arrange alternative sources of manufacturing, however, this may require additional time and resources, thereby straining the capacity of the Company.

*Electrovaya 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 will continue to incur significant costs and invest considerable resources designing and testing batteries for use with, or incorporation into, specific products. Significant revenue from these investments may not be achieved*



*for a number of years, if at all. Moreover, these batteries may never be profitable and even if they are profitable, operating margins may be low.*

*The development by the Company of new applications for its rechargeable batteries is a complex and time-consuming process. New battery designs and enhancements to existing battery models can require long development and testing periods. Significant delays in new product releases or significant problems in creating new products could negatively impact the Company's revenues.*

Electrovaya 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 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.

*Electrovaya may not be able to compete effectively with other manufacturers of compact or large format rechargeable 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 computer, wireless devices and various power systems may reduce the need for its batteries.*

The market for rechargeable batteries is competitive. Electrovaya believes it is well positioned to compete in the market for compact rechargeable batteries, which is already very large and growing rapidly. There are currently seven or more principal competitors, primarily well capitalized companies based in China, Japan and Korea, which have in aggregate a dominant market position in the lithium ion and lithium ion polymer battery sector. 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 Electrovaya's products in the electronics markets that it targets.

Electrovaya 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.

*Electrovaya 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 Electrovaya 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 Electrovaya's products could adversely affect the Company's ability to manufacture or sell its products or result in increased costs or liability. Finally, Electrovaya 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 the risks of product liability, Electrovaya 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. In certain situations or applications, battery power may be a more attractive environmental solution than other energy sources utilizing fossil fuels or creating emissions.

*Electrovaya is developing and manufacturing batteries for applications such as life support systems for NASA where a power failure could be catastrophic, adversely affecting the Company's reputation and resulting in increased costs or liability.*

To mitigate the risks associated with the use of batteries for life support systems, Electrovaya has increased quality control activities and closely followed the specifications provided by NASA. The Company believes it is using amongst the safest materials available for these applications, and all flight-grade batteries are thoroughly tested.

*Electrovaya may not be able to successfully market its battery technology and products, and because its SuperPolymer® technology is relatively new, these batteries may not perform as well as anticipated. The Company expects to continue 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, Electrovaya's revenue profile and cash flows may be severely affected. The Company continues 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.*

*If overall market demand for laptop computers and other portable electronic devices declines significantly, and consumer and corporate spending for such products declines, Electrovaya's revenue growth will be adversely affected. Additionally, the Company's*

*revenues would be unfavorably impacted if customers reduce their purchases of new products or upgrades to the Company's existing product lineup if such new offerings are not perceived to add significant new functionality or other value to prospective purchasers.*

The PowerPad® 80, 120 and 160 products and Scribbler ® Tablet PC series of products have undergone extensive user testing and have now been sold commercially to well-established corporate users, distributors and value added resellers with positive early results. Electrovaya has an aggressive marketing program in place, including trade show participation and advertising campaigns. The Company has a dedicated sales team to aggressively market and sell its products in the United States and Canada. Electrovaya has adopted 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 ensure it minimizes reliance on any one customer.

*If the Company fails to manage growth successfully, it could experience delays, cost overruns or other problems. Similarly, the Company is in a specialized industry where qualified, key personnel may be difficult to retain or replace on a cost-effective basis.*

Electrovaya will continue to monitor its staffing requirements for its manufacturing facility and its needs at the senior management levels and for specialized personnel in various disciplines or areas of expertise.

*If Electrovaya 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 Electrovaya is unable to maintain registration of 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.*

Electrovaya will continue to file patent applications and 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**

The cash position of Electrovaya remained relatively flat during the quarter and we are working hard to create sustainable revenue growth and improve profit margins.

During the quarter, we established a new partnership with NYSERDA that should enhance our ability to leverage the US market, as evidenced by our work to complete a prototype electric lawn-mower for golf course applications. We intend to continue to develop other global partnerships in the electric vehicle market while we drive profitable

R&D services revenue from specialty battery applications and increased revenue from our consumer electronics business.