

## **Management Discussion and Analysis of Financial Condition and Results of Operations (As of June 17, 2009)**

*This MD&A contains projections and other forward-looking statements regarding future events. Such statements are predictions, which may involve known and unknown risks, uncertainties and other factors, which could cause the actual events or results and company plans and objectives to differ materially from those expressed. For information concerning factors affecting the Company's business, the reader is referred to the documents that the Company files from time to time with applicable Canadian securities and regulatory authorities.*

This discussion and analysis of the results of operations of Quest PharmaTech Inc. (“Quest” or the “Company”) should be read in conjunction with the unaudited consolidated financial statements and accompanying notes for the three months ended April 30, 2009 and the audited consolidated financial statements for the years ended January 31, 2009 and January 31, 2008. This discussion and analysis provides an update to the discussion and analysis prepared for the year ended January 31, 2009. The unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada (Canadian GAAP) and have not been reviewed by the Company’s auditors. This discussion and analysis provides information on the operations of Quest on a consolidated basis. All amounts are expressed in Canadian dollars unless otherwise noted and references to the term “year” refer to the fiscal year ended January 31<sup>st</sup>. Additional information related to the Company is on SEDAR at [www.sedar.com](http://www.sedar.com).

### **Q1, 2010 Development Highlights:**

- Finalized and signed clinical trial agreements with centers in Edmonton and Toronto for initiation of SL052 Prostate Cancer clinical trial. Submissions made to respective research ethics boards;
- Continued to make clinical progress in the development of SL017 for dermatology applications;
- Notified that positive research findings on SL052 photo-immunotherapy accepted for publication in peer-reviewed journal. The article, entitled, “Exploitation of Immune Response-Eliciting Properties of Hypocrellin Photosensitizer SL052-Based Photodynamic Therapy for Eradication of Malignant Tumors”, will be published in an upcoming edition of *Photochemistry and Photobiology*
- Initiated evaluation and selection of second-generation formulations from several nanoparticle-based candidates to further adapt Hypocrellin-based photodynamic and sonodynamic therapy to a wider spectrum of clinical needs including cancer treatment;
- Presented Company’s updated profile to institutional and retail investors at BioFinance 2009 conference in Toronto.

## Overview

Quest is committed to building shareholder value through the discovery, development and commercialization of new pharmaceutical products. It is developing a series of products for the treatment of cancer and dermatological conditions, based on its SonoLight Technology platform.

The patented SonoLight Technology is based on a unique non-toxic family of photosensitizing and sonosensitizing, small molecular weight compounds called Hypocrellin, isolated from a parasitic fungus that grows on bamboo trees in China. Quest is developing these compounds as drugs, as well as developing novel means of activating and delivering them to target tissues. Quest's products are expected to offer high selectivity and efficacy with minimal side effects.

### Products under Development:

**Dermatology:** The Company's lead product, SL017, is a topical formulation indicated for dermatology applications. The utility of SL017 with Intense Pulsed Light has already been demonstrated for hair removal applications in a Phase I clinical trial. The Company has recently completed the enrollment of 110 patients in a Phase II clinical trial for the same indication. Use of SL017 with a light-based hair removal device is likely to overcome some of the limitations associated with the light treatment alone. In addition, SL017 has undergone a positive Canadian Phase I clinical trial for Actinic Keratosis and is also being evaluated for acne treatment in a pre-clinical study.

**Oncology:** A second product from the SonoLight platform, SL052, is an injectable formulation that has recently received approval from Health Canada's Therapeutic Product Division to initiate a Phase I clinical trial for the treatment of prostate cancer. The clinical trial will be conducted in two stages. The first stage of the study will evaluate the prostate gland distribution of SL052 in up to six subjects undergoing radical prostatectomy. In the second stage of the study, the safety and preliminary efficacy of SL052 PDT treatment with light dose escalation will be studied in 12 subjects with localized prostate cancer. The treatment response will be monitored by MRI, prostate biopsy and changes in baseline PSA levels. The animal studies completed at the Cross Cancer Institute in Edmonton, Alberta, indicate that SL052 has the potential to destroy cancerous tumors in the prostate while limiting collateral damage to healthy tissue.

### Products and Technology under Discovery:

**Immuno Photodynamic Therapy:** Our research has shown that photodynamic therapy can augment the therapeutic effects of immunomodulators such as antibodies, antigens, cytokines and immunoadjuvants in cancer patients. With a strong intellectual property position to use SL052 with immunotherapy, the Company has received encouraging results from its collaborative research agreement with the BC Cancer Agency to investigate the therapeutic and mechanistic aspects of anti-tumor effect achieved in mice by treatment combining photodynamic therapy based on SL052 with various immunotherapeutic agents. The results from the BC Cancer Agency demonstrate that SL052 is an effective immuno-stimulant when combined with immunotherapy for the removal of solid tumors.

**Sonodynamic Therapy:** Sonodynamic therapy (SDT) involves the administration of non-toxic pharmaceutical agents which may be activated deep within the body, by ultrasound, which is in itself non-toxic. The goal of SDT is to provide effective and specific eradication or control of tumors, while minimizing or eliminating toxicity and morbidity to the remainder of the patient. The Company has initiated a discovery program to develop an adjuvant therapy to standard treatment for peritoneal and/or thoracic carcinomatosis, commonly consequential to a variety of late-stage malignancies. The treatment involves introduction of a non-toxic sonosensitizer to the peritoneal or thoracic space during routine therapeutic drainage of ascitic fluid or of pleural effusion, respectively. The sonosensitized tumor cells and micrometastases will be selectively destroyed by exposure to ultrasound energy applied to the exterior of the abdomen or thorax. This study is being funded in part from a research grant from National Research Councils' Industrial Research Assistant Program.

**Novel Formulations:** The Company has initiated a research program to develop novel topical and injectable formulations that will lead to a high therapeutic drug accumulation in the target tissue, and be highly potent with negligible toxicity and rapid clearance from blood and skin. In a strategic alliance with IntelligentNano, a spin-off company from the Canadian National Research Council's National Institute for Nanotechnology, Quest has created a water-soluble nano-formulation of SL052 and SL017.

**Raw Material Manufacturing:** Quest PharmaTech and the Alberta Research Council (ARC) have formed a strategic alliance to develop fermentation based technologies to manufacture Hypocrellin B, one of the essential ingredients for the SonoLight Technology. The ARC will undertake research to develop a semi-synthetic method for the manufacture of Hypocrellin B. If the project is successful, Quest will receive an exclusive license to the developed technology from the ARC to manufacture and commercialize HB based products, including SL017 for dermatology and SL052 for oncology applications.

### **Financial Results**

Net consolidated income for the three month period ended April 30, 2009 was \$126,978 or \$0.00 per share as compared to consolidated income of \$74,809 or \$0.00 per share for the three month period ended April 30, 2008. Research and development expenditures totaled \$119,316 while general and administrative expenses were \$198,935 for the same period. As of April 30, 2009, the Company had cash and cash equivalents of \$737,355 (June 17, 2009 – approximately \$560,000). The Company also has debt of \$500,000 in the form of a convertible debenture (exercisable at \$0.25 and due on March 22, 2010).

On a forward going basis, the Company is eligible to receive up to \$54,000 in government grants in fiscal 2010 to offset the costs to develop its ultrasound activation technology.

### **Results of Operations**

Net consolidated income for the three months ended April 30, 2009 was \$126,978 or \$0.00 per share on a fully diluted basis as compared to consolidated income of \$74,809 or \$0.00 per share for the three months ended April 30, 2008. Cash provided by (used in) operations for the three

months ended April 30, 2009 was \$142,529 as compared to (258,884) for the three months ended April 30, 2008.

### Revenues:

The following table identifies the changes in revenue for the three month period ended April 30, 2009 compared to the three month period ended April 30, 2008.

Revenue	2009	2008	Increase (decrease)
	\$	\$	\$
License fees	500,000	500,000	-
Market distribution rights	2,000	2,000	-
Total revenue from operations	502,000	502,000	-

### License Fees

During the three month period ended April 30, 2009, the Company recognized license fee revenue of \$500,000 for oncology applications.

The oncology license agreement requires the Company to pay royalties on all future net revenue from the commercialization of the Company's oncology products. Under the terms of the agreement, the Company is required to use commercially reasonable efforts to initiate a Phase I clinical trial for photodynamic therapy treatment of prostate cancer. The Company is recognizing the license fee in relation to the costs incurred with these efforts and has recognized \$500,000 of the license fee for the three month period ended April 30, 2009.

### Expenses

The following table identifies the changes in general and administrative expense for the three month period ended April 30, 2009 compared to the three month period ended April 30, 2008.

General and administrative expense	2009	2008	Increase (decrease)
	\$	\$	\$
Salaries, wages and benefits	75,037	79,213	(4,176)
Other support costs	4,331	6,768	(2,437)
Consulting	69,271	12,500	56,771
Accounting / audit fees	800	976	(176)
Legal fees	3,287	582	2,705
Public company related costs	23,873	10,081	13,792
Rent	2,831	2,812	19
Travel	16,159	6,835	9,324
Insurance	3,346	3,575	(229)
Total general and administrative expense	198,935	123,342	75,593

Overall, general and administrative costs have increased during the three month period in 2009 compared to 2008, due primarily to an increase in consulting fees and business development costs. Public company related costs and travel costs have increased during the three month period in 2009 compared to 2008 due to increased investor relations efforts that were initiated by the Company.

The following table identifies the changes in research and development (R&D) expense for the three month period ended April 30, 2009 compared to the three month period ended April 30, 2008.

Research and development expense	2009	2008	Increase (decrease)
	\$	\$	\$
Salaries, wages and benefits	61,080	50,125	10,955
Sub-contract, consulting and clinical trials	51,752	208,878	(157,126)
Rent	6,605	6,561	44
Legal (patent prosecution)	10,453	22,932	(12,479)
Supplies	8,633	4,005	4,628
Other R&D costs	13,134	9,691	3,443
<b>Gross research and development expense</b>	<b>151,657</b>	<b>302,192</b>	<b>(150,535)</b>
Less			
NRC-IRAP funding	(32,341)	-	32,341
<b>Research and development expense (net)</b>	<b>119,316</b>	<b>302,192</b>	<b>(182,876)</b>

Overall, R&D expenses have decreased during the three month period in 2009 compared to 2008 due to a decrease in expenditure activity with the Company's clinical trials. Most of this decrease is reflected in subcontract, consulting and clinical trial costs which have decreased by more than \$157,000. Salary costs have increased due to an increase in R&D staff in 2009 compared to the three month period in 2008. Patent costs have decreased in 2009 compared to 2008 due to a decrease in patent prosecution activity.

### **Stock-Based Compensation Expense**

During the three month period ended April 30, 2009, the Company granted a total of 100,000 (for the three month period ended April 30, 2008 – nil) stock options, as per the Company's Stock Option Plan. These options were granted to a consultant of the Company and carry an exercise price of \$0.25. 50,000 of these options vested in the quarter with an estimated fair value of \$1,500 which was recognized as an expense and credited to contributed surplus for the period.

### **Deferred Revenue**

The Company has recorded deferred revenue (current portion \$258,000 and long term portion \$91,667) in connection with amounts received for market distribution rights and license fees that relate to future periods. \$250,000 relates to the Company's oncology license agreement and will be recognized in the second quarter. The remaining \$99,667 (\$8,000 current and \$91,667 long term) relates to the market distribution rights for Asian hair removal and is being recognized over a remaining 12.5 year period.

## Outstanding Share Data

The Company has the following securities outstanding as at June 17, 2009:

Common shares issued and outstanding at April 30, 2009	68,197,580
Common shares held for cancellation	22,540
Stock options outstanding as at April 30, 2009	4,034,000
Stock options granted since April 30, 2009	25,000
Stock options expired since April 30, 2009	-
Stock options outstanding as at June 17, 2009	4,059,000
Common shares issuable upon conversion of \$500,000 convertible debenture	2,000,000

Fully diluted common shares assuming the exercise of all stock options and the convertible debenture – 74,279,120.

## Financial Instruments

**Fair Value** - Given their short-term maturity, the fair value of cash and cash equivalents, accounts receivable, marketable securities, accounts payable and accrued liabilities and the convertible debenture approximate the carrying value.

**Foreign Currency Risk** - The Company has assets and liabilities that are denominated in foreign currencies and that are exposed to the financial risk of earnings fluctuation arising from changes in foreign exchange rates and the degree of volatility of those rates. The Company does not currently use derivative instruments to reduce its exposure to foreign currency risk.

**Liquidity Risk** - Company's exposure to liquidity risk is dependent on its ability to raise funds to meet its commitments and sustain its operations. The Company controls liquidity risk by managing its working capital and by securing additional funds through equity, debt or partnering transactions.

**Credit Risk** - Financial instruments that subject the Company to credit risk consist primarily of cash equivalents and accounts receivable. To minimize its exposure to credit risk for cash equivalents, the Company invests in liquid, fully guaranteed deposits with its financial banker (\$660,000 at period end). At April 30, 2009, approximately 36% of accounts receivable were due from one organization.

**Market Risk** - The Company owns investments in common shares of publicly traded companies that subject the Company to market risk. As market prices change, the Company's income and the value of its marketable securities are affected. The Company expects that its exposure to market risk will be short lived as the investments are viewed as temporary in nature.

**Interest Rate Risk** - Interest rate risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Financial assets and financial liabilities with variable interest rates expose the Company to cash flow interest rate risk. The Company's cash and cash equivalents are comprised of highly liquid investments that earn interest at market rates. Interest on the long term debt is at fixed rates. Consequently, the Company is exposed to fair value changes on long-term debt when the market rate on interest

changes. Accounts receivable, accounts payable and accrued liabilities bear no interest. The Company manages its interest rate risk by maximizing the interest income earned on excess funds while maintaining the liquidity necessary to conduct operations on a day-to-day basis.

### **Liquidity and Capital Resources**

As noted in the Risks and Uncertainties section below, the Company's ability to continue as a going concern is uncertain and is dependent upon its ability to raise additional capital to successfully complete its research and development programs, commercialize its technologies, conduct clinical trials and receive regulatory approval for its products.

At April 30, 2009, cash and cash equivalents was \$737,355 as compared to \$594,826 at January 31, 2009.

During the three month period ended April 30, 2009, the Company recognized revenue of \$502,000 related to licensing fees and market distribution rights and \$32,341 in R&D grant funding from the National Research Council Industrial Assistance Program.

Cash provided by (used in) operations was \$142,529 for the three month period ended April 30, 2009 compared to (\$258,884) for the three month period ended April 30, 2008.

The Company negotiated an extension to the maturity date of the \$500,000 convertible debenture which is now due March 22, 2010. The interest rate and conversion rate remain unchanged at 9% per annum and \$0.25 per common share, respectively.

In December, 2007, the Company announced that it had entered into an agreement with a third party to license the oncology applications of the Company's SonoLight technology. As consideration, the Company received an initial payment of \$1,000,000, \$1,500,000 during fiscal 2009 and \$500,000 during the three month period ended April 30, 2009.

The Company also expects to receive research grant funding of up to \$54,000 during the next five months to offset the costs to develop its ultrasound activation technology.

The Company continues to implement a disciplined approach to containing costs and is focusing on programs aimed at achieving near-term goals.

Quest's funding needs will vary as its drug development products move into and through clinical trials. Based on current operating budgets and assuming the ongoing divestiture of non-core assets, management believes that the capital resources of the Company should be sufficient to fund operations to the end of fiscal 2010.

The Company will seek additional capital through equity financings, licensing arrangements involving its core technologies and strategic partnerships.

### **Demand Notes and Related Party Transactions**

There were no related party transactions during the three month period ended April 30, 2009.

## **Accounting Pronouncements for Future Adoption International Financial Reporting Standards**

In February, 2008, the Canadian Accounting Standards Board confirmed that Canadian public enterprises will need to adopt International Financial Reporting Standards (“IFRS”) for years beginning on or after January 1, 2011. The Company will therefore be required to report using IFRS commencing with its unaudited interim consolidated financial statements for the three months ended April 30, 2011, which must include the interim results for the three months ended April 30, 2010 prepared on the same basis. IFRS uses a conceptual basis similar to Canadian GAAP, but there are some significant differences on recognition, measurement and disclosures.

Implementing IFRS will have an impact on accounting, financial reporting and supporting IT systems and processes. Accordingly, the Company is in the process of developing its IFRS changeover plan which will include considerations such as measures to provide training to key finance personnel, to review contracts and agreements and to increase the level of awareness and knowledge among management, the Board of Directors and the Audit Committee. Additional resources may be engaged to ensure the timely conversion to IFRS.

The Company is in the process of completing the initial diagnostic between Canadian GAAP and IFRS. While the effects if IFRS have not been fully determined, the Company has identified a number of key areas where it is likely to be impacted by changes in accounting policies. These include:

- Property plant and equipment
- Intangible assets
- Impairment of assets
- Provisions and contingent liabilities
- Share based compensation
- Presentation of cash flows

A detailed diagnostic is planned for Q3, fiscal 2010.

## **Disclosure Controls and Procedures**

The management of Quest is responsible for establishing and maintaining disclosure controls and procedures for the Company and is continuing with the implementation of disclosure controls and procedures, to provide reasonable assurance that material information relating to the Company, including its consolidated subsidiaries, is made known to Quest management particularly during the period in which the filings are being prepared.

## **Internal Control Over Financial Reporting**

The Company’s management is responsible for establishing and maintaining adequate internal control over financial reporting. Management has taken steps to improve the procedures and provide maintenance related to an effective design for the Company’s internal controls and procedures over financial reporting. Management continues to note weaknesses in internal controls over financial reporting including those related to the limited number of accounting staff



members resulting in a lack of segregation of duties. Management will continue with the implementation of procedures aimed at minimizing the risk of material error in its financial reporting and will seek outside expertise when the need arises.

## **Risks and Uncertainties**

Going concern uncertainty - The Company's financial statements have been prepared on a going concern basis which presumes the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. The Company has experienced significant operating losses and cash outflows from operations since its inception. The Company's ability to continue as a going concern is uncertain and is dependent upon its ability to raise additional capital to successfully complete its research and development programs, commercialize its technologies and conduct clinical trials and receive regulatory approvals for its products. It is not possible at this time to predict the outcome of these matters.

Quest's proprietary technologies are in various stages of development and some technologies have not received regulatory approval to begin clinical trials. It will be necessary for the Company to produce sufficient preclinical data in order to receive regulatory approval to begin clinical trials. There is no assurance that regulatory approval will be received to begin clinical trials. For the proprietary technologies that have received regulatory approval to begin clinical trials, future success will depend upon the ability of the Company to move the products through clinical trials, the effect and safety of these products, the timing and cost to receive regulatory and marketing approvals and the filing and maintenance of patent claims.

Quest's proprietary technologies have exposure to risks associated with commercialization. Even after product approval is obtained, there is no assurance that the Company will have a sufficient market for its products or the working capital required for commercialization.

The Company maintains clinical trial liability and product liability insurance; however, it is possible that this coverage may not provide full protection against all risks.

The Company may be exposed to risks associated with malfunctioning equipment, catastrophic events and other events within and outside of the Company's control. The Company maintains insurance believed to be adequate to cover any eventuality, but there is no guarantee that coverage will be sufficient for all purposes.

To a large degree, the Company's success is dependant upon attracting and retaining key management and scientific personnel to further the Company's drug development programs. There is a risk that required personnel may not be available to the Company when needed and, as a result, this may have a negative impact on the Company.

Quest must continue to raise additional capital through the exercise of stock options and warrants, issuing new share capital through equity financing, licensing arrangements and/or strategic partnerships. The Company's ability to raise additional capital will depend upon the progress of moving its drug development products into and through clinical trials and the strength of the equity markets, which are uncertain. There can be no assurance that additional capital will be available.