

## **Management Discussion and Analysis of Financial Condition and Results of Operations (As of June 29, 2005)**

*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 Altachem Pharma Ltd. (“Altachem” or the “Company”) should be read in conjunction with the unaudited consolidated financial statements and accompanying notes for the three months ended April 30, 2005 and the audited consolidated financial statements for the years ended January 31, 2005 and January 31, 2004. This discussion and analysis provides an update to the discussion and analysis prepared for the year ended January 31, 2005. 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 Altachem 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).

### **Overview**

Altachem is committed to the development and commercialization of new pharmaceutical products. It is developing a series of products for the treatment of cancer and other proliferative diseases based on its Sonolight and CDK platforms. It also has a profitable product in Accu-MAb<sup>TM</sup>, a monoclonal-based diagnostic kit for whooping cough. The Company also operates manufacturing facilities located in Edmonton, Alberta and Shanghai, China. These facilities are certified compliant with international recognized quality systems standards.

During the three month period ended April 30, 2005, the Company experienced numerous significant developments. Altachem began fiscal 2006 with a focused business strategy under the guidance of a new and experienced management team and a newly-appointed veteran biotech CEO. Highlights of the Company’s strategy, announced February 23<sup>rd</sup>, 2005, are:

- \* a concentration of the Company’s efforts on drug development, with a special focus on the Company’s novel and proprietary photodynamic treatments for cancer and other proliferative diseases.
- \* a de-emphasis of the Company’s developmental programs in AIDS and the divesting of certain other non-core assets.

- \* discontinuation of the Company's operations in China. This discontinuance will likely involve a sale of the Shanghai-based companies and/or facilities and possible repatriation of various technologies and products for subsequent development by the Company or licensing partners.
- \* initial recapitalization of the Company. In the first months of 2005, in a difficult financial market, the Company has attracted over \$2.5 million in equity and debenture financing and has thus been able to retire the bulk of its debt and begin to deploy new resources to program development.

As a result of the strategic re-alignment described above, the Company expects to incur significant expenditures on drug and product development in the next year. Altachem is also focusing on increasing revenue from manufacturing and product sales to cover drug and product development costs.

### **Manufacturing Operations**

The previous strategy of Altachem's manufacturing operations was to provide positive cash flow to support drug and product development. However, net cash flowing from most of these activities has not met expectations so the Company has decided to divest all but the most profitable of these operations.

Therefore, on July 30, 2004, Altachem sold the assets associated with its contract manufacturing operations in Edmonton, Alberta for the sum of \$460,000. Altachem's Edmonton, Alberta manufacturing facility was primarily used to manufacture breath test kits under an agreement that was to expire in November 2007.

#### *Edmonton, Alberta Manufacturing Facility*

Altachem continues to maintain a manufacturing facility located in Edmonton, Alberta to manufacture Accu-MAB™, a whooping cough test kit sold by Altachem and which is profitable. This manufacturing facility is approximately 800 square feet, is equipped with clean room facilities and is certified compliant with internationally recognized quality systems standards, ISO 9001:2000 and ISO 13488 and CMDCAS (Health Canada's requirement for medical devices).

#### *Shanghai, China Manufacturing Facility*

Shanghai Hua Gao Pharmaceutical Pellet Core Company Ltd. ("SHGP") is a wholly owned foreign subsidiary of Altachem and is located in Shanghai, China. SHGP operates a 38,660 square foot manufacturing facility and a 9,100 square foot office building. SHGP has been audited and approved by the State Drug Administration in China and has been issued licenses by the Chinese Government to manufacture pharmaceutical pellet core and to manufacture Bionex disinfectant. The manufacturing facility is designed to produce high quality, low cost products that meet both domestic and export quality standards. SHGP currently manufactures pharmaceutical pellet core and has established a production line to manufacture Bionex hard surface disinfectant.

Altachem's strategy is to discontinue operations in China and so the Company has retained several agents on a non-exclusive basis to represent the sale of SHGP. Several parties have received the information memorandum, toured the facility and begun their due diligence.

## Results of Operations

It is important to note that Altachem's net consolidated loss includes significant non-cash items. These non-cash items include amortization, options/shares issued as consideration for services and options issued to employees and future income taxes. For the three months ended April 30, 2005 and April 30, 2004, amortization was \$96,849 and \$374,850 respectively, shares/options issued for services was nil and \$96,500 respectively, options issued to employees was \$45,333 and nil, respectively and future income taxes was nil and \$45,763, respectively. Net consolidated loss for the three months ended April 30, 2005 was \$814,670 or \$0.02 per share on a fully diluted basis as compared to a consolidated loss of \$1,003,806 or \$0.03 per share for the three months ended April 30, 2004. After adjusting for non-cash items, cash flows used to fund operations for the three months ended April 30, 2005 were \$1,206,687 as compared to \$278,280 for the three months ended April 30, 2004.

## Revenues

Prior to July 30, 2004, Altachem generated revenue from three sources: contract manufacturing of diagnostic test kits, sales of Accu-MAb<sup>TM</sup>, a whooping cough diagnostic test kit and sales of pharmaceutical pellet core. On July 30, 2004 the Company has sold its assets relating to the contract manufacturing operations in Edmonton, Alberta. As a result, the Company no longer generates revenue from contract manufacturing of diagnostic breath test kits. The following table identifies the changes in revenue for the three months ended April 30, 2005 compared to the three months ended April 30, 2004.

Revenue	2005	2004	Increase (decrease)
	\$	\$	\$
Accu-MAb <sup>TM</sup>	48,221	43,672	4,549
Pharmaceutical pellet core	18,282	23,180	(4,898)
Total revenue from continuing operations	66,503	66,852	(349)
Revenue from discontinued operations	nil	179,948	(179,948)

Sales of Accu-MAb<sup>TM</sup> increased slightly for the three month ended April 30, 2005 compared to the three month period ended April 30, 2004. The Company is looking to further expand sales of Accu-MAb<sup>TM</sup> in Canada, the United States and to other countries. The decrease in revenue in connection with the Company's discontinued operations is due to the Company sale of the contract manufacturing facility in July, 2004.

The direct costs associated with manufacturing are classified as materials, supplies and subcontracts expense. For continuing operations, materials, supplies and subcontracts expenses for the three month period ended April 30, 2005 were \$25,594 as compared to \$25,573 for the three month period ended April 30, 2004.

## Expenses

The following table identifies the changes in General and Administrative expense for the three month period ended April 30, 2005 compared to the three month period ended April 30, 2004.

General and administrative expense	2005	2004	Increase (decrease)
	\$	\$	\$
Salaries, wages and benefits	207,667	409,855	(202,188)
Other support costs	97,328	33,227	64,101
Consulting	22,000	22,570	(570)
Legal fees	20,816	86,042	(65,226)
Audit and accounting fees	nil	17,807	(17,807)
Public company related costs	18,633	14,653	3,980
Rent	nil	22,560	(22,560)
Travel	15,073	35,653	(20,580)
Insurance	10,879	16,313	(5,434)
Total general and administrative expense	392,396	658,680	(266,284)

Salaries, wages and benefits decreased due to the resignations of certain of the Company's senior officers in 2004. Legal fees have decreased primarily due to the fact that significant legal expenses were incurred in 2004 in connection with the June 2004 Annual and Special Shareholders Meeting. Rent has decreased due to a change in the allocation of rental costs to reflect that the Company's facility space is devoted to R&D activities. Travel expense has decreased due to a decrease in travel activity.

The following table identifies the changes in Research and Development (R&D) expense for the three month period ended April 30, 2005 compared to the three month period ended April 30, 2004.

Research and development expense	2005	2004	Increase (decrease)
	\$	\$	\$
Salaries, wages and benefits	156,258	122,170	34,088
Sub-contract and consulting	79,781	304,711	(224,930)
Rent	52,971	43,037	9,934
Legal (patent prosecution)	18,625	65,709	(47,084)
Supplies	39,751	38,718	1,033
Other R&D costs	28,357	40,943	(12,586)
Total research and development expense	375,743	615,288	(239,545)

Salaries, wages and benefits increased due to the hiring of additional R&D staff. The decrease in sub-contract and consulting expense, in legal patent prosecution costs, and for R&D expenditures in total reflects the Company's focus of expenditures on the Company's core R&D technologies.

## Discontinued Operations

On July 30, 2004 the Company sold its assets relating to the contract manufacturing operations in Edmonton, Alberta. The following table identifies the activity in connection with the Company's discontinued operations for the three month period ended April 30, 2005 compared to the three month period ended April 30, 2004.

Discontinued operations	2005	2004	Increase (decrease)
	\$	\$	\$
Revenue	nil	179,948	(179,948)
Direct Costs	nil	109,077	(109,077)
General and administrative expenses	nil	42,341	(42,341)
Gain on disposal of assets	nil	nil	
Income / (loss)	nil	28,530	(28,530)

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

During the three month period ended April 30, 2005, the Company granted a total of 800,000 stock options, as per the Company's Stock Option Plan compared to 250,000 options for the three month period ended April 30, 2004. All 800,000 options were granted to an employee and vest over a three year period (for the three month period ended April 30, 2004, the 250,000 options were granted to non-employees). For the three month period ended April 30, 2005, the fair value of the vested options, \$45,333, was recognized as an expense and credited to contributed surplus (for the three month period ended April 30, 2004 – \$96,500).

### **Chinese Operations**

In February, 2005, the Company's Board made a decision to discontinue operations in China. This decision may involve a sale of the Shanghai-based companies and/or facilities and possible repatriation of various technologies and products to Canada.

In April, 2005, the Company applied for and received local China government approval for the early termination and cancellation of Shanghai Altachem Pharma Biotechnology Ltd. ("SACP"). The Company is taking steps to complete the process and repatriate SACP's assets back to Canada. This process is expected to be completed during the 3<sup>rd</sup> quarter of calendar 2005.

The financial aspects of Altachem's Chinese operations must be converted into Canadian dollars to prepare annual and quarterly financial statements. At April 30, 2005 SACP and SHGP are treated as integrated operations and as a result, any foreign exchange gain or loss is included in income. For the three month period ended April 30, 2005, a foreign exchange gain of \$41,781 compared to a foreign exchange gain of \$557,723 for the three month period ended April 30, 2004 has been recorded on the statement of operations. The foreign exchange gain for the period relates to the Company's investment in China and is due primarily to an increase in the value of the US dollar and Chinese yuan relative to the Canadian dollar. The variance for the three month period ended April 30, 2005 compared to the three month period ended April 30, 2004 relates to a decrease in the amount of the Company's investment in China.

### **Liquidity and Capital Resources**

At April 30, 2005, cash and cash equivalents was \$1,919,913 as compared to \$1,931,293 at January 31, 2005.

The majority of Company's cash balance at year end is held by its Chinese subsidiary, SACP. During the three month period ended April 30, 2005, the Company received initial approval from

the Chinese Authorities to collapse SACP and return its cash and technology assets to Canada. This process is expected to be completed during the period August to October, 2005.

During the three month period ended April 30, 2005, the Company obtained \$75,000 of additional bridge financing in the form of an interest bearing loan from a director (see “Related Party Transactions” for further details). Also during the period, the Company repaid a portion of its bridge financing loans such that, at April 30, 2005, \$689,248 was outstanding. The Company intends to repay the remainder of these obligations during Q2 and Q3 of fiscal 2006.

During the three month period ended April 30, 2005, the Company recognized approximately \$60,000 of federal government assistance in the form of a National Research Council Industrial Research Assistance Program (“IRAP”) grant to cover salaries and contractor fees related to the development of the Company’s photodynamic therapy for prostate cancer, based on the Company’s lead proprietary hypocrellin derivative. This funding is part of a \$295,000 grant the Company is eligible to receive for the period to March 31, 2006.

On March 23, 2005, the Company issued a \$1,000,000 principal amount 8% secured convertible debenture with a one year maturity to two arm’s length parties. The debenture is collateralized by funds held in SACP. The debenture is repayable in blended monthly installments of \$6,667 with the balance, including accrued interest, due on March 22, 2006. The debenture may be converted into common shares of the Company at a price of \$0.45 per common share and may be redeemed at any time by the Company.

On March 7 and May 17, 2005, the Company completed the first and second tranche of a non-brokered private placement with the sale of 5,972,000 units for gross proceeds of \$1,493,000 (net proceeds of approximately \$1,432,000). Each unit is comprised of one common share and one-half share purchase warrant. Each whole warrant entitles the holder to acquire one additional common share at a price of \$0.45 at any time within one year of issuance. The proceeds from these private placements will be for general corporate purposes and for working capital.

Based on current operating budgets and assuming repatriation and liquidation of assets from Altachem’s Chinese subsidiaries, management believes that the capital resources of the Company should be sufficient to fund operations into the first quarter of calendar 2006. Altachem’s funding needs will vary as its drug development products move into and through clinical trials.

The Company will seek additional capital through the sale of non-core assets, further equity financings, licensing arrangements, strategic partnerships and/or financings from directors.

## **Related Party Transactions**

During the year ended January 31, 2005, the Company obtained bridge financing in the amount of \$650,000 from companies controlled by two former directors, Mr. Wayne Minion and Mr. Andrew Boddy. The bridge financing was payable on demand, carried an interest rate of 4% and originally was collateralized by cash held in SACP. In August, 2004, a statement of claim was filed by the two companies alleging non-payment of the bridge financing plus accrued interest.

In December, 2004, a Consent Judgment was granted in connection with the Statement of Claim which requires the Company to pay the bridge financing plus accrued interest of \$ 7,530 and legal costs of \$8,000. The Consent Judgment replaces the bridge financing and represents an unsecured claim against all of the assets of the Company. During the three month period ended April 30, 2005, the Company paid a portion of this obligation such that, at April 30, 2005, \$365,908 was outstanding. Subsequent to April 30, 2005, the Company paid the remainder of this obligation.

During the year ended January 31, 2005, the Company obtained additional bridge financing totaling \$134,000 from a former director, Mr. Robert Sydenham and from a company controlled by Mr. Sydenham. This bridge financing is unsecured, has no fixed terms of repayment, and is non-interest bearing, except for an \$80,000 tranche which bears interest at 6.25% per annum. At April 30, 2005, \$98,340 was outstanding. Subsequent to April 30, 2005, the Company paid off the remainder of this obligation.

On February 8, 2005, the Company obtained additional bridge financing in the amount of \$75,000 from Dr. Madiyalakan. At that time, the Company converted all of Dr. Madiyalakan's loans and \$20,000 of legal expenses incurred by Dr. Madiyalakan on behalf of the Company to interest bearing notes (totaling \$225,000) at 6% per annum. At April 30, 2005, all of this debt was outstanding.

## **Subsequent Events**

On May 10, 2005, the Company announced that it had granted a total of 500,000 stock options to 3 officers and 2 non-management directors. The exercise price of the options is \$0.25. All allocations will be subject to approval by the TSXV. Subsequent to this announcement, the Company determined not to finalize the granting of stock options to two Officers and the grant was not made.

On May 17, 2005, the Company closed the second and final tranche of a non-brokered private placement with the sale of 4,200,000 units for gross proceeds of \$1,050,000 (net proceeds of approximately \$1,005,000). Each unit consists of one common share and one half of one non-transferable share purchase warrant. Each whole warrant entitles the holder to acquire one additional common share at a price of \$0.45 at any time within one year of issuance.

The Company has been awarded a grant from Alberta Ingenuity Fund to cover salary expenditures related to the development of the Company's photodynamic therapy for prostate cancer. The \$110,000 grant is to be paid over a 24 month period commencing in May, 2005.

## **Risks and Uncertainties**

Altachem'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.

Altachem'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.

Given their short-term maturity, the fair value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities and demand notes approximate the carrying value.

The fair value of the obligation under capital lease, calculated at the present value of future contractual payments of principal and interest and discounted at the current market rate of interest available to the Company for debt instruments with similar terms and maturity, approximates the carrying value.

A substantial portion of the Company's cash reserves are denominated in US dollars and Chinese Yuan. In addition, the Company has a US dollar denominated capital lease obligation. These result in financial risk due to fluctuations in the value of the Canadian dollar relative to the US dollar and the Chinese Yuan. The Company does not use derivative financial instruments to reduce its foreign exchange exposure.

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.

Altachem 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. As described above in the Liquidity and Capital Resources section, the majority of the Company's cash balance is held in its Chinese subsidiary. The accessibility and the effective use of these funds in the short and long-term will determine the Company's need to raise additional capital.