

## **Management Discussion and Analysis of Financial Condition and Results of Operations (As of June 28, 2006)**

*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, 2006 and the audited consolidated financial statements for the years ended January 31, 2006 and January 31, 2005. This discussion and analysis provides an update to the discussion and analysis prepared for the year ended January 31, 2006. 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).

### **Overview**

Quest 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.

During the three month period ended April 30, 2006 (**and subsequent thereto**), the Company experienced numerous significant developments. Highlights are:

- the resignation, effective March 24, 2006, of Dr. David J. Cox as the Company's President and CEO. Dr. Cox continues to hold a position as Director on the Company's Board.
- the six month extension of the maturity of the Company's 8% \$1,000,000 convertible debenture, which is now due September 22, 2006.
- the receipt of bridge financing of \$150,000 in March and April, 2006 and \$50,000 in May, 2006, at 6% from companies controlled by two of the Company's directors.

- the sale of one of the Company's non-core assets, Accu-MAb, to a third party for proceeds of \$200,000.
- the receipt of Phase 1 clinical trial results in connection with the Company's lead product candidate, SL017 Topical Gel.

The Company continues its focus on the sale of its remaining non-core assets to help cover drug and product development costs. Due to the sale or held for sale nature of the Company's non-core assets and technologies, this management discussion and analysis has been separated between continuing and discontinued operations. A summary of the Company's projects follows (in approximate order of resource allocation).

## **HYPOCRELLIN-BASED TECHNOLOGIES**

This technology platform is based on a unique, non-toxic family of photosensitizing and sonosensitizing compounds. The active ingredient is a derivative of Hypocrellin B ("HB"), a small molecular compound isolated from parasitic fungi on bamboo. Quest has formulated HB derivatives into a topical gel (SL017), and an injectable solution (SL052).

### **HB Topical - SL017**

This gel penetrates skin and can potentially be used to treat various skin conditions such as acne, actinic keratosis, psoriasis, etc. HB gels target a large patient population and will face comparatively less stringent regulatory requirements than injectable HB compounds. The Company is currently in a phase I clinical trial for actinic keratoses, with eight out of 12 patients enrolled. The Company has recently received results in connection with its phase I clinical trial for acne and hair removal, and the Company intends to initiate a 40 patient clinical trial, as soon as possible, to determine the appropriate light dose to be used with SL017 for cosmetic hair removal applications.

### **HB Injectable – SL052**

Quest has developed SL052, which may have utility in the photodynamic therapy treatment of prostate cancer. During 2004, the Company entered into an agreement with Dr. Ronald B. Moore, the Alberta Cancer Board and the Cross Cancer Institute to complete preclinical studies on SL052 prior to entering phase I clinical trials. Over the next year, the Company will continue to focus on the development of HB Injectable for prostate cancer and will incur additional costs associated with accumulating preclinical data to advance this technology into clinical trials.

Quest is also developing SL052 (SDT) for peritoneal carcinomatosis to demonstrate the proof-of-principle for a Sonodynamic Therapy approach for the treatment of cancer. The Company has identified peritoneal carcinomatosis as a suitable indication for such applications. The Company is trying to identify a partner to undertake development of an ultrasound transducer suitable for abdominal and thoracic activation of the sonosensitizer, SL052, previously administered to the ascites fluid or pleural effusion of patients with advanced carcinomatosis.

## OTHER DRUG DEVELOPMENT PROGRAMS

### 2127 (formerly CDK Immunomodulator)

2127 is a novel immunomodulator with anti-cancer properties targeted to inhibit cyclin-dependant kinases (“CDKs”) functionality and prevent the growth of cancer cells. CDKs are the proteins that control the growth cycle of cancer cells. By using small molecule CDK inhibitors to disrupt the cycle of a cancer cell, the growth and spread of cancer can be stopped. During the prior year, the Company completed initial studies on 2127. Based upon results compared with other CDK inhibitors in its class, the Company is proceeding with patent applications to increase the value of this technology. Further development of 2127 is on hold pending receipt of additional Company funding.

### Results of Operations

It is important to note that Quest’s net consolidated loss includes significant non-cash items. These non-cash items from continuing operations include amortization, options/shares issued as consideration for services and options issued to employees. For the three months ended April 30, 2006 and April 30, 2005, amortization from continuing operations was \$24,325 and \$34,902 respectively, shares/options issued for services was \$4,500 and \$nil respectively, and options issued to employees was \$nil and \$45,333, respectively. Net consolidated loss for the three months ended April 30, 2006 was \$472,863 or \$0.01 per share on a fully diluted basis as compared to a consolidated loss of \$814,670 or \$0.02 per share for the three months ended April 30, 2005. After adjusting for non-cash items, cash flows used to fund continuing operations for the three months ended April 30, 2006 were \$221,482 as compared to \$1,166,580 for the three months ended April 30, 2005.

### Expenses

The following table identifies the changes in General and Administrative expense for the three month period ended April 30, 2006 compared to the three month period ended April 30, 2005.

General and administrative expense	2006	2005	Increase (decrease)
	\$	\$	\$
Salaries, wages and benefits	52,076	193,168	(141,092)
Other support costs	7,740	29,333	(21,593)
Consulting	44,500	22,000	22,500
Legal fees	2,879	20,816	(17,937)
Public company related costs	9,465	18,633	(9,168)
Rent	2,762	-	2,762
Travel	5,346	15,073	(9,727)
Insurance	14,747	10,879	3,868
Total general and administrative expense	139,515	309,902	(170,387)

Salaries, wages and benefits, other support costs and travel expenses have decreased due to the Company’s continued cost containment efforts. Consulting costs increased due to the Company’s increased use of outside consultants in Q1, fiscal 2007. Legal fees in Q1, fiscal 2007 have decreased due to a reduction in legal activity in Q1, fiscal 2007 compared to Q1, fiscal 2006.

The following table identifies the changes in research and development (R&D) expense for the three month period ended April 30, 2006 compared to the three month period ended April 30, 2005.

Research and development expense	2006	2005	Increase (decrease)
	\$	\$	\$
Salaries, wages and benefits	93,571	156,258	(62,687)
Sub-contract and consulting	24,792	79,781	(54,989)
Rent	17,773	52,971	(35,198)
Legal (patent prosecution)	44,172	18,625	25,547
Supplies	25,414	39,751	(14,337)
Other R&D costs	22,896	28,357	(5,461)
Total research and development expense	228,618	375,743	(147,125)

Except for legal (patent prosecution) costs, R&D expenses have decreased due to the Company's continuing efforts to cut costs where possible in order to conserve resources. Legal (patent prosecution) costs have increased due to an increase in patent activity in Q1, fiscal 2007 compared to Q1, fiscal 2006.

#### **DISCONTINUED OPERATIONS**

On July 30, 2004 the Company sold its assets relating to the contract manufacturing operations in Edmonton, Alberta, to Isodiagnostika Inc. The Company received proceeds of \$460,000 and realized a gain on sale of \$360,207.

On August 18, 2005, the Company received China government approval to wind-up and dissolve SACP and repatriate its remaining assets to Canada. This repatriation process was completed in September, 2005.

On September 2, 2005, the Company completed the dissolution of its inactive, wholly-owned subsidiary, Altachem Pharma (Barbados) Inc.

On October 28, 2005, the Company completed the wind-up and dissolution of 790563 Alberta Ltd. into its parent, Steroidogenesis Inhibitors Canada Inc.

As part of the Company's decision in February, 2005 to divest itself of its non-core assets, the Company has also presented the assets and liabilities of SHGP and the activity related to AccuMAB, Bionex, Anticort and HIP as discontinued operations.

The following table identifies the activity in connection with the Company's discontinued operations for the three month period ended April 30, 2006 compared to the three month period ended April 30, 2005.

Discontinued operations	2006	2005	Increase (decrease)
	\$	\$	\$
Revenue	25,032	66,503	(41,471)
Direct costs	9,354	28,970	(19,616)
Gross Margin	15,678	37,533	(21,855)
General and administrative expenses	31,229	82,493	(51,264)
Amortization expense	32,266	61,947	(29,681)
Interest expense	12,924	14,770	(1,846)
Interest income	(17)	(358)	341
Income / (loss) from discontinued operations	(60,724)	(121,319)	60,595

#### Manufacturing Operations:

The previous strategy of Quest'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 of these operations.

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

#### *Edmonton, Alberta Manufacturing Facility*

Up until June 9, 2006, Quest maintained a manufacturing facility located in Edmonton, Alberta to manufacture Accu-MAb™, a whooping cough test kit sold by Quest. This manufacturing facility is approximately 800 square feet, and 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). Effective June 9, 2006, the Company sold its interest in the Accu-MAb technology to a third party. As a result of the sale, the Company will no longer maintain this manufacturing facility.

#### *Shanghai, China Manufacturing Facility*

Shanghai Hua Gao Pharmaceutical Pellet Core Company Ltd. ("SHGP") is a wholly owned foreign subsidiary of Quest and is located in Shanghai, China. SHGP operates a 38,660 square foot manufacturing facility and 9,100 square feet of office space. 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.

Included in the assets held for sale balance in the April 30, 2006 financial statements is the manufacturing facility owned by SHGP. This facility includes manufacturing equipment and buildings.

As part of Quest's strategy to discontinue operations in China, Quest continues to search for a third party to purchase the SHGP assets.

The financial aspects of Quest's Chinese operations must be converted into Canadian dollars to prepare annual and quarterly financial statements. At April 30, 2006, SHGP is treated as an integrated operation and as a result, any foreign exchange gain or loss is included in income. Prior to the Company's dissolution of SACP, this company was also treated as an integrated operation. For the three month period ended April 30, 2006, a foreign exchange gain of \$11,811 compared to a foreign exchange gain of \$41,781 for the three month period ended April 30, 2005 has been recorded on the statement of operations. The foreign exchange gains relate to fluctuations in the value of the U.S. dollar and Chinese yuan relative to the Canadian dollar and also to a decline in the Company's net investment in China.

#### Revenues:

Prior to July 30, 2004, Quest 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 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. Effective June 9, 2006, the Company sold its interest in the Accu-MAb technology. The following table identifies the changes in revenue for the three month period ended April 30, 2006 compared to the three month period ended April 30, 2005.

Revenue	2006	2005	Increase (decrease)
	\$	\$	\$
Accu-MAb <sup>TM</sup> (discontinued operations)	23,020	48,221	(25,201)
Pharmaceutical pellet core (discontinued operations)	2,012	18,282	(16,270)
Total revenue from discontinued operations	25,032	66,503	(41,471)

Sales of Accu-MAb<sup>TM</sup> decreased during the three month period ended April 30, 2006 due to a decrease in sale orders over the period. The decrease in revenue in connection with the Company's pharmaceutical pellet core operation is due to a scaling down of this operation in anticipation of a sale of the SHGP facility.

#### Stock-Based Compensation Expense

During the three month period ended April 30, 2006, the Company granted a total of 150,000 (for the three month period ended April 30, 2005 – 800,000) stock options, as per the Company's Stock Option Plan, including nil (2005 – 800,000) to employees and 150,000 (2005 – nil) to non-employees. The fair value of these options, \$4,500, was recognized as an expense and credited to contributed surplus for the three month period ended April 30, 2006 (for the three month period ended April 30, 2005 – \$45,333).

## **Liquidity and Capital Resources**

As noted in the Overview section above, 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, 2006, cash and cash equivalents was \$49,325 as compared to \$115,505 at January 31, 2006.

During the year ended January 31, 2006, the Company was 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 being received over a 24 month period commencing in May, 2005. \$12,000 of funding was recognized during the three month period ended April 30, 2006.

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

On March 14, 2006, the Company obtained bridge financing of \$60,000 from a company controlled by Dr. Madiyalakan, the Company's Executive Chairman. This bridge financing is unsecured, has no fixed terms of repayment and carries an interest rate of 6% per annum, with interest payable monthly.

On March 21, 2006, the Company signed an amendment to the \$1,000,000 convertible debenture agreement to extend the maturity date of the convertible debenture from March 22, 2006 to September 22, 2006.

On April 10, 2006, the Company obtained bridge financing of \$90,000 from a company controlled by Dr. Madiyalakan. This bridge financing is unsecured, has no fixed terms of repayment and carries an interest rate of 6% per annum, with interest payable monthly.

On May 1, 2006, the Company obtained bridge financing of \$50,000 from a company controlled by Dr. Donald Rix, a director of the Company. This bridge financing is unsecured, has no fixed terms of repayment and carries an interest rate of 6% per annum, with interest payable monthly.

Effective June 9, 2006, the Company sold its interest in the Accu-MAb technology to a third party for proceeds of \$200,000, comprised of \$100,000 in cash and two \$50,000 promissory notes, due August 1, 2006 and November 1, 2006, respectively.

Quest'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 and strategic partnerships.

Based on current operating budgets and assuming the ongoing divestiture of non-core assets including the repatriation and liquidation of assets from Quest's Chinese subsidiary, management

believes that the capital resources of the Company should be sufficient to fund operations to the end of the second quarter of fiscal 2007.

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

## **Related Party Transactions**

On August 8, 2005, the Company entered into an agreement with a company controlled by Dr. Madiyalakan to provide consulting services. The consulting agreement requires the Company to make monthly payments of \$7,500 and is for a term of 12 months.

On March 14, 2006, the Company obtained bridge financing of \$60,000 from a company controlled by Dr. Madiyalakan. This bridge financing is unsecured, has no fixed terms of repayment and carries an interest rate of 6% per annum, with interest payable monthly.

On April 10, 2006, the Company obtained bridge financing of \$90,000 from a company controlled by Dr. Madiyalakan. This bridge financing is unsecured, has no fixed terms of repayment and carries an interest rate of 6% per annum, with interest payable monthly.

## **Subsequent Events**

On May 1, 2006, the Company obtained bridge financing of \$50,000 from a company controlled by Dr. Donald Rix. This bridge financing is unsecured, has no fixed terms of repayment and carries an interest rate of 6% per annum, with interest payable monthly.

Effective June 9, 2006, the Company sold its interest in the Accu-MAb technology to a third party for proceeds of \$200,000, comprised of \$100,000 in cash and two \$50,000 promissory notes, due August 1, 2006 and November 1, 2006, respectively.

## **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 and it is expected to continue to experience negative cash flows from operations in the coming fiscal year. The Company had a working capital deficiency of \$2,321,601 and a shareholders' deficiency of \$1,319,551 as at April 30, 2006.

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.

Given their short-term maturity, the fair value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities and convertible debenture 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 portion of the Company's cash reserves are denominated in U.S. dollars and Chinese yuan. In addition, the Company has a U.S. dollar denominated capital lease obligation. These result in financial risk due to fluctuations in the value of the Canadian dollar relative to the U.S. 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.

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.