

**WELICHEM BIOTECH INC.**  
FORM 51 – 102F1  
MANAGEMENT DISCUSSION AND ANALYSIS  
Period Ended August 31, 2006

The following discussion and analysis, prepared as of October 10, 2006, should be read together with the audited financial statements for year ended May 31, 2006 and unaudited financial statements for period ended August 31, 2006 and related notes attached thereto, which are prepared in accordance with Canadian generally accepted accounting principles. All amounts are stated in Canadian dollars unless otherwise indicated.

This Management Discussion & Analysis summarizes the activities of the Company to date, and provides financial information for the period ended August 31, 2006. The discussion contains forward-looking statements that involve risks and uncertainties. Such information is considered reasonable by the Company's management at the time of preparation.

### **Overview**

Welichem Biotech is a pharmaceutical drug research and development company focused on the discovery and commercialization of small molecule drugs to treat unmet healthcare needs. The Company aims to bring better and safer drugs to market that have high efficacy and low side effects. Two groups of lead drug compounds are being developed: one to target on autoimmune/inflammatory diseases and the other on cancerous tumors.

Some of the highlights of the first quarter of the year are:

- Successful conclusion of a trio of preclinical tests of the lead drug candidate, WBI-1001, against psoriasis.
- A metabolic breakdown product of WBI-1001 has been identified and synthesized.
- Significant progress in optimization of the synthesis of the anti-cancer drug compound, WBI-2100, was attained.
- Achieved further understanding of the mode of action of the anti-cancer drug compound, WBI-2100, through *in vivo* tests.
- The pipeline was further advanced through the identification of the novel structure and the bioactivity of three compounds of interest to the Company.

Welichem's lead drug candidate, WBI-1001, targets mild and moderate forms of psoriasis, which is 80% of those persons suffering from the disease. Conclusion of the formal preclinical tests of this drug candidate, that will enable regulatory

application, is anticipated by the end of the year. Once approved, this drug candidate would be developed and applied as a topical cream, thus avoiding the inconvenience of the more intrusive, needle injection common to some therapies.

The synthesis of the Company's anti-cancer drug compound, WBI-2100, that was achieved earlier is now being optimized so as to facilitate commercial manufacture. This requires an extensive knowledge of chemistry and an appreciation of the bioactive and formulation opportunities offered by such novel compounds.

Results from a series of murine tests by Welichem on the efficacy and mode of action of WBI-2100 are being supplemented by *in vivo* data supplied by its partner, Celestial Pharmaceuticals (Shenzhen) Ltd. The synergistic effect against tumors when WBI-2100 is applied in combination with selected commercial anti-cancer drug therapies is especially encouraging particularly in the view of the low level of side effects.

The tapping of Welichem's attractive pipeline source has resulted in the identification and synthesis of three, novel, small molecules with bioactivities of interest. The Company will now undertake a series of sequential tests to determine the potential of these compounds as therapeutic drugs prior to targeting them for detailed preclinical evaluation.

### **Results of Operations**

Presently, Welichem has no revenues and it is unlikely to be in a position to generate sufficient revenues to meet its ongoing operating and capital expenses for the foreseeable future. Welichem has incurred operating losses since its inception.

The net loss for the 3-month period ended August 31, 2006 was \$866,701 (2005 - \$687,553) and 3 cents per share (2005 - 2 cents per share). The Research & Development Expenses for this period were \$615,122 (2005 - \$569,559). Major expenses included \$424,552 (2005 - \$462,759) in subcontractors, supplies and materials and \$193,752 (2005 - \$106,800) in wages and benefits, including stock-based compensation costs of \$57,536 (2005 - \$5,535). The Company received \$3,182 (2005 - \$nil) in government assistance and other subsidies.

Administrative expenses for this period were \$273,917 (2005 - \$120,506). Major expenses included \$181,223 (2005 - \$28,632) in wages and benefits, including stock-based compensation costs of \$136,416 (2005 - \$10,715), \$24,686 (2005 - \$21,282) in rent, \$19,059 (2005 - \$10,688) in regulatory expenses, \$12,000 (2005 - \$nil) in consulting fees, \$8,454 (2005 - \$6,311) in travel and related costs, \$6,712 (2005 - \$20,939) in professional fees, and \$5,282 (2005 - \$8,793) in office and miscellaneous expenses.

Factors that contributed to higher administrative expenses in this quarter included:

- i) higher stock-based compensation costs;
- ii) higher wages and benefits due to increase in staff;
- iii) higher regulatory fees;
- iv) increase in rent due to expanded facility; and,
- v) higher amortization expenses.

### **Financing**

From its incorporation in 1995, the Company has financed its operations through private sale of equity securities, and through interest income, refundable tax credits and government grants. While the Company has no financing activities in this year, it has developed a plan to finance future operations.

During the quarter, the Company closed a non-broker private placement of 37,536,000 units at a purchase price of \$0.075 per unit, for total gross proceeds of up to \$2,815,200. Each unit consists of one common share and one-half of one share purchase warrant. Each whole warrant is exercisable into one common share at a price of \$0.20 for a period of 24 months from the date of issuance of the share purchase warrant. A finder's fee of \$255,870 was paid in connection with the private placement. All securities issued under this private placement will have a 6-month hold period expiring on January 12, 2007.

### **Liquidity**

During the 3-month period ended August 31, 2006, the Company relied on the proceeds from the non-broker private placement completed in May 2005 and July 2006 to continue its operations and Research and Development activities.

At August 31, 2006, the Company had \$2,084,412 (May 31, 2006 - \$265,593) in cash and cash equivalents. The Company's net working capital position as at May 31, 2006 was \$2,025,893 (May 31, 2006 - \$142,696).

With its current funds on hand, together with interest income, the Scientific Research and Experimental Development Program (SRED) refund tax credit, and the funding from the Industrial Research Assistance Program ("IRAP") of the National Research Council of Canada, the Company anticipates that it has sufficient funds for operations to the spring of 2007.

Until the Company achieves the licensing or drug commercialization stages, it will continue to fund its operations from a combination of the sale and issuance of equity securities and government subsidies.

## **Risks and Uncertainties**

The Company's business is in the development stage and does not generate cash flow from operations to adequately fund its activities and has thus relied principally on the issuance of securities for financing. There is no assurance that such financing will be available on a timely basis under terms acceptable to the Company.

It should be noted that the Company's funding needs may vary depending upon several factors, including the progress and nature of research and development initiatives, the ability to attract and maintain strategic alliances, the Company's decision to in-license technology, acquisition and unforeseen costs associated with undertaking pre-clinical/clinical studies.

If adequate funding is not available, the Company may be required to delay, reduce or eliminate one or more of its research and development programs or obtain funds through arrangements with corporate partners or others that may require the Company to relinquish greater or all rights to product candidates at an earlier stage of development or on less favourable terms than the Company would otherwise seek. Insufficient funding may also require the Company to relinquish rights to certain of its technologies that the Company would otherwise develop itself.

## **Summary of Annual Information**

	Year Ended May 31, 2006 (Audited)	Year Ended May 31, 2005 (Audited)	Year Ended May 31, 2004 (Audited )
Total Income	(25,787)	(23,827)	49,576
Loss for the year	(2,378,867)	(1,198,931)	(226,013)
Loss per Common Share - basic and fully diluted	(0.08)	(0.06)	(0.02)
Total Assets	759,574	2,742,374	1,118,971
Total Current Liabilities	289,920	161,698	41,545
Total Long-term Liabilities	0	0	0
Shareholders' Equity	469,654	2,580,676	1,077,426

## **Summary of Quarterly Information**

	1 <sup>st</sup> Quarter Ended August 31, 2006 (Unaudited)	4 <sup>th</sup> Quarter Ended May 31, 2006 (Unaudited)	3 <sup>rd</sup> Quarter Ended Nov. Feb. 28, 2006 (Unaudited)	2 <sup>nd</sup> Quarter Ended Nov. 30, 2005 (Unaudited)	1 <sup>st</sup> Quarter Ended August 31, 2005 (Unaudited)	4 <sup>th</sup> Quarter Ended May 31, 2005 (Unaudited)	3 <sup>rd</sup> Quarter Ended Nov. Feb. 28, 2005 (Unaudited)	2 <sup>nd</sup> Quarter Ended Nov. 30, 2004 (Unaudited)
Total Income	22,338	(68,376)	5,689	2,805	2,512	8,361	27,503	(57,557)
Loss for the period	(866,701)	(754,920)	(306,241)	(630,153)	(687,553)	(425,064)	(243,878)	(406,669)
Loss per Common Share – basic and fully diluted	(0.03)	(0.03)	(0.01)	(0.03)	(0.02)	(0.02)	(0.01)	(0.02)
Total Assets	2,588,236	759,574	1,097,927	1,367,595	1,974,935	2,742,374	1,580,989	1,720,385
Total Liabilities	232,001	289,920	18,773	35,826	65,562	161,698	14,611	162,884
Shareholders' Equity	2,356,235	469,654	1,079,154	1,331,769	1,909,373	2,580,676	1,566,378	1,557,501

### **Off Balance Sheet Arrangements**

The Company is not aware of any material off balance sheet arrangements requiring disclosure.

### **Related Party Transactions**

During the 3-month period ended August 31, 2006, the Company paid \$95,250 (2005 - \$66,100) in wages, and \$2,100 (2005 – \$4,000) in directors' fees to its former and current officers and directors.

### **Critical Accounting Policies and Estimates**

The Company's significant accounting policies are disclosed in Note 3 to the audited financial statements as at August 31, 2006. Critical accounting policies and estimates include:

#### **Cash equivalents**

The Company considers all highly liquid financial instruments with an original maturity of 90 days or less to be cash equivalents. Cash equivalents are recorded at the lower of cost plus accrued interest and market value.

#### **Short-term investments**

The Company considers all highly liquid financial instruments with an original

maturity greater than 90 days to be short-term investments. Short-term investments are recorded at the lower of amortized cost or market value.

### **Intangible assets**

Intangible assets consist of patent rights and applications costs incurred for the filing of patents. Intangible assets are amortized on a straight-line basis over the maximum period of ten years from the time of acquisition.

### **Stock-based compensation**

The Company uses the fair value method for stock-based compensation granted to employees and non-employees of the Company and all direct awards of stock, in accordance with the CICA Handbook Section 3870 "*Stock-Based Compensation and Other Stock-Based Payments*". The fair value of stock options is determined by the *Black-Scholes Option Pricing Model* with assumptions for risk-free interest rates, dividend yields, volatility factors of the expected market price of the Company's common shares and an expected life of the options. The fair value of direct awards of stocks is determined by the quoted market price of the Company's stock.

### **Research and development expenses**

Research and development costs are expensed as incurred unless such development costs meet the criteria under Canadian generally accepted accounting principles for deferral and amortization. Development costs which meet generally accepted criteria for deferral are capitalized and amortized against earnings over the estimated period of benefit. As at August 31, 2006 and 2005, the Company had not deferred any development costs.

### **Government assistance and other subsidies**

Government assistance and other subsidies are recorded as either a reduction of the cost of the applicable assets or credited in the statement of operations as determined by the terms and conditions of the agreement under which the assistance is provided to the Company.

### **Research and development tax credits**

Refundable tax credits are recorded as either a reduction of the cost of applicable assets or credited in the statement of operations depending on the nature of the expenditures which gave rise to the credits. Claims for tax credits are accrued upon the Company attaining reasonable assurance of collection from the Canada Revenue Agency.

Investment tax credits are accrued on qualifying expenditures when there is reasonable assurance that the credits will be recovered. Research and development tax credits were only available to the Company up to October 31, 2004, prior to amalgamation and becoming a publicly listed entity.

### **Income taxes**

Future income taxes are recorded using the asset and liability method whereby future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using the enacted or substantively enacted tax rates expected to apply when the asset is realized or the liability settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that substantive enactment or enactment occurs. To the extent that the Company does not consider it more likely than not that a future tax asset will be recovered, it provides a valuation allowance against the excess.

### **Subsequent Events**

Subsequent to this reporting period, the Company received a cheque from Canada Revenue Agency for its Scientific Research and Experimental Development Program (SRED) refund tax credit claimed for the period prior to November 1, 2004.

### **Outstanding Share Data**

As at October 10, 2006, the Company had the following outstanding securities:

(1) Common Shares issued	66,316,325
(Shares in escrow: 6,627,066)	
(2) Stock Options	5,609,600
(3) Warrants	18,768,000

### **Additional Information**

Additional Information relating to the Company is available on SEDAR ([www.sedar.com](http://www.sedar.com)).