



Afexa Life Sciences Inc.

## First Quarter Report

### **Management's Discussion and Analysis**

For the three month period ended December 31, 2009

## Management's Discussion and Analysis

### For the three month period ended December 31, 2009

The following Management's discussion and analysis ("MD&A") for Afexa Life Sciences Inc. ("Afexa" or the "Company"), prepared as at February 10, 2010, should be read in conjunction with the Company's audited consolidated financial statements for the year ended September 30, 2009 and accompanying notes. The MD&A contains disclosure of material changes occurring up to and including February 10, 2010. The consolidated financial statements of Afexa Life Sciences Inc. are prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are reported in Canadian dollars. All references to GAAP refer to Canadian generally accepted accounting principles. These accounting principles require the Company to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses, and related disclosure of contingent assets and liabilities. Management believes that the estimates and assumptions, which it relies upon, are reasonably based on information available at the time that these estimates and assumptions were made. These estimates and assumptions have been discussed with the Audit Committee of the Board of Directors of Afexa Life Sciences Inc. Actual results may differ under different assumptions and conditions. See the Advisory Regarding Forward-looking Statements section at the end of this report.

Additional information on the Company, including the Company's most recently filed Annual Information Form, MD&A and audited financial statements, is available at [www.sedar.com](http://www.sedar.com).

### COMPANY OVERVIEW

Afexa Life Sciences Inc. is a life sciences and technology company, founded in 1992 and headquartered in Edmonton, Alberta, Canada. The Company has developed, commercialized and patented a proprietary technology, known as ChemBioPrint®, which is used in the discovery and biological standardization of natural products that deliver consistent, verifiable and provable health benefits. Using the ChemBioPrint product discovery and standardization platform, the Company's scientists are able to identify precisely the chemical profile and biological activity of natural products. The process involves a combination of chemical and biological fingerprinting to ensure that the creation and scientific substantiation of its natural health products are safe, effective and consistent. The Company is committed to using a pharmaceutical model (involving rigorous drug discovery and testing methods) to develop natural therapeutics for health maintenance and disease prevention. Its efforts in scientific research and product innovation are key factors in enabling the Company to secure the trust of consumers, trade professionals, healthcare practitioners and government. The Company's lead product, COLD-FX®, is designed to aid in the prevention and relief of colds and flu by strengthening the immune system. COLD-FX continues to be the number one selling cold and flu remedy in Canada (source: The Nielsen Company MarketTrack National all channel dollar sales for the categories of Cold Remedies and Supplements and Products, 52 weeks ending December 19, 2009).

The vision of the Company is to deliver the most trusted health brand on the planet. This vision continues to be a basic premise for the business, and management's intent is to become a leader in Canada in preventative health care.

### HIGHLIGHTS

Combined retail dollar sales to end consumers of regular and extra strength COLD-FX increased by 25% for the 12 weeks ended December 19, 2009 as compared to the corresponding period in the prior year, per point of sales data received from The Nielsen Company, and the Company remains the number one selling cold and flu remedy in Canada for the 52 and 12 week periods ended December 19, 2009.

COLD-FX also remains the number one pharmacist and doctor recommended natural cold remedy as reported by Pharmacy Post (now Drug Store Canada) and The Medical Post publications, respectively.

Revenue for the three months ended December 31, 2009 was \$29.5 million which is a new benchmark for the Company, given its highest previous quarterly revenue was \$21.3 million, two years ago in the first quarter of 2008. This new Company record for quarterly revenue is \$9.8 million or 49.8% higher than the prior year's first quarter. Management attributes the increase in revenue to an increase in demand for its product, based on public awareness and concern about flu. This corresponded with the World Health Organization announcement, and media coverage thereon, of a pandemic strain of the flu.

## Management's Discussion and Analysis *(continued)*

Margin increased from 71.6% in the first quarter of fiscal 2009 to 72.5% in the first quarter of fiscal 2010 primarily due to the averaging down of fixed overhead costs as a percentage of revenue.

Net earnings increased \$4.0 million (141.2%) as compared to the first quarter of fiscal 2009 because of the higher revenue and margins, which were only partially offset by an increase in marketing and research and development costs.

The Company's cash position at December 31, 2009 increased to \$16.2 million, a \$12.7 million (364.1%) increase from the prior quarter's ending cash position of \$3.5 million. The increase in cash was primarily derived from cash generated from the increased revenue.

### Summary of consolidated financial results

The following table summarizes key financial data and should be read in conjunction with the Company's December 31, 2009 quarterly financial statements. Such financial statements are prepared in accordance with GAAP and are reported in Canadian dollars.

### Summary of consolidated financial results

*(in thousands except for per share amounts)*

	First quarter ended December 31, 2009	First quarter ended December 31, 2008
Revenue	\$29,547	\$19,721
EBITDA <sup>1</sup>	10,274	4,698
Net earnings	6,816	2,807
Earnings per common share - basic	0.06	0.03
Earnings per common share - diluted	0.06	0.03
Cash flow prior to working capital changes <sup>1</sup>	6,979	2,856
	As at December 31, 2009	As at September 30, 2009
Working capital <sup>1</sup>	\$21,878	\$15,135
Total assets	50,656	37,672
Total long-term debt and obligations under capital lease (including current portion)	6,207	6,359
Shareholders' equity	29,952	23,060

*There was no income or loss caused by discontinued operations and/or extraordinary items.*

<sup>1</sup> Earnings before interest, income taxes, depreciation and amortization ("EBITDA"), cash flow prior to working capital changes and working capital are non-GAAP measures and may not be comparable to similar measures presented by other issuers. Reconciliations of these measures to the most directly comparable financial measure calculated and presented in accordance with Canadian GAAP along with explanations as to why they are used is provided below in the "Non-GAAP Financial Measures and Reconciliations" section.

## RESULTS OF OPERATIONS FOR THE THREE MONTH PERIOD ENDED DECEMBER 31, 2009

### Revenue

Revenue for the three month period ended December 31, 2009 was \$29.5 million, an increase of \$9.8 million (49.8%), as compared to \$19.7 million for the three month period ended December 31, 2009. This is due to an increase in demand for the Company's lead product COLD-FX, which corresponded to an increase in the incidence of the flu, reported widely in the media. Many of the Company's retail customers increased their inventories of cold and flu remedy and related products during the three months ended December 31, 2009. Despite Afexa anticipating higher demand for its product during this period and deliberately building up inventories prior to the cold and flu season, orders exceeded supply for some of the Company's product sizes of COLD-FX for short periods of time, while the Company quickly responded by increasing its production of finished inventory. Combined retail dollar sales to end consumers of regular and extra strength COLD-FX increased by 25% for the 12 weeks ended December 19, 2009 as

compared to the corresponding period in the prior year, per point of sales data received from The Nielsen Company, and the Company remains the number one selling cold and flu remedy in Canada for the 52 and 12 week periods ended December 19, 2009.

The Company's three largest Canadian customers contributed 55% of Afexa's consolidated revenue in the first quarter of fiscal 2010 compared to 60% in the comparable quarter of fiscal 2009. The change in the customer percentage concentration is attributed to timing of shipments rather than a broad change in customer buying patterns or change in the number and type of the Company's major customers.

Revenue from the Company's United States customers was nil in the first quarter of fiscal 2010 as compared to \$0.6 million in the first quarter of fiscal 2009. The Company, over the past two years, has focused almost all of its marketing and sales activities in Canada and no United States marketing and sales expenditures occurred in the first quarter of fiscal 2010. Management continues to expect revenue from the United States to be limited as the Company continues to focus activities in Canada. The Company may focus future United States revenue and marketing activity through internet channels.

### **Cost of goods sold and gross profit**

Gross profit dollars for the first quarter of fiscal 2010 was \$21.4 million compared to \$14.1 million in the first quarter of fiscal 2009. The \$7.3 million increase is due to higher revenue. Gross profit expressed as a percentage of revenue for the three month period ended December 31, 2009 increased to 72.5% from 71.6% in the first quarter of fiscal 2009. The increase is due to fixed overhead costs being averaged down as a percentage of revenue.

### **Selling, general and administration**

Selling, general and administration costs increased \$1.4 million to \$9.6 million for the first quarter of 2010 as compared to \$8.2 million in the same quarter for fiscal 2009. The primary reason for the increase is due to marketing costs. The Company increased its advertising campaigns in the first quarter to raise brand awareness during a period when the incidence of colds and flu were on the increase. Increased marketing expenses were incurred in relation to the launch of IMMUNITY-FX™ and a number of Olympic related expenses were incurred in the first quarter of fiscal 2010 as the Company prepared to activate a number of Olympic related marketing initiatives. Sales expenses also increased due to broker commissions related to the higher revenue.

### **Research and development**

Research and development costs of \$1.5 million are \$0.7 million higher than the \$0.8 million incurred in the first quarter of fiscal 2009. The Company continues to focus more resources towards research and development activities. The increase in expenses is due to an increase in staff and an increase in clinical trial activity. The Company is working towards accelerating research on new product development and to commence additional research and clinical testing on additional natural extracts and ingredients that may potentially become commercial products. Partially offsetting the research and development costs in the first quarter of fiscal 2010 is the recording of \$0.1 million (2008 - \$0.2 million) of scientific research and experimental development tax credits ("SR&ED").

### **Stock-based compensation**

Stock-based compensation increased by \$0.1 million for the three month period ended December 31, 2009, as compared to the same period in fiscal 2009. The increase is largely due the issuance of 1,285,000 options as part of a Company wide option grant late in the second quarter of 2009 and due to the adoption of a deferred share unit ("DSU") plan for non-employee directors and a restricted share unit ("RSU") plan for eligible employees. The Company granted an additional 40,473 DSUs during the first quarter of fiscal 2010.

### EBITDA

The EBITDA for the three month period ended December 31, 2009 increased by \$5.6 million to \$10.3 million as compared to the same period in fiscal 2009, primarily due to an increase in revenue partially offset by planned increases in marketing and research and development costs as described earlier in this report.

### Amortization

For the first quarter of fiscal 2010, amortization of \$0.3 million approximates the amount expensed in the same period in fiscal 2009. Additional amortization of new equipment purchased in the first quarter of fiscal 2010 and the last three quarters of fiscal 2009 was partially offset by older assets becoming fully depreciated.

### Interest expense and interest revenue

Interest expense of \$95 thousand in the first quarter of 2010 decreased by \$32 thousand as compared to the first quarter of fiscal 2009 due to lower debt balances as well as interest rates being lower than in the first quarter of fiscal 2009. The majority of the Company's utilized bank financing is for a mortgage collateralized by the Company's facilities in Edmonton, Alberta. The interest rate on this debt is the bank's prime lending rate plus 1.25%, however, the rate was the bank's prime lending rate plus 1.00% throughout the first quarter of fiscal 2009. Despite the 0.25% increase in the rate, the bank's prime lending rate decreased from an average of 3.83% in the first quarter of fiscal 2009 to 2.25% in the first quarter of fiscal 2010 resulting in an overall decrease of 1.58%.

### Foreign currency gains and losses

The Company is invoiced for certain services and materials in foreign currencies (primarily United States dollars) and has foreign operations whose statutory accounts are denominated in United States dollars. These foreign operations are integrated with the Company's consolidated operations. Under GAAP, monetary items are translated at the exchange rate in effect at the balance sheet date; non-monetary items are translated at historical exchange rates; revenue and expense items are translated at the exchange rate in effect on the dates they occur; depreciation or amortization of assets are translated at historical exchange rates using the same historical exchange rate as the assets to which they relate. The Company did not enter into any foreign currency hedge instruments in the first quarter of fiscal 2010 or fiscal 2009. At the end of the first quarter of fiscal 2009 customer deposits were higher and primarily from United States customers. Exchange rate changes applied to United States related customer deposits at the end of the first quarter of fiscal 2009 is the primary reason for the \$0.5 million exchange loss in that period. In the first quarter of fiscal 2010, customer deposits are primarily denominated in Canadian dollars; therefore, the Company is far less exposed to changes in foreign exchange rates. A \$20 thousand foreign exchange loss was incurred in the first quarter of fiscal 2010.

### Income taxes

Income tax expense of \$3.0 million in the first quarter of fiscal 2010 is \$1.5 million higher than in the first quarter of fiscal 2009 due to earnings before income taxes being \$5.5 million higher in fiscal 2010 as compared to fiscal 2009.

### Quarterly information

(in thousands except for per share amounts)

	For the year ended September 30								
	2010	2009			2008				
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Revenue	\$29,547	\$15,557	\$6,195	\$6,119	\$19,721	\$14,044	\$3,355	\$10,715	\$21,275
Net earnings (loss)	6,816	2,782	(1,120)	(3,168)	2,807	531	(1,970)	(768)	6,799
Earnings (loss) per common share - basic	0.06	0.03	(0.01)	(0.03)	0.03	0.00	(0.02)	(0.01)	0.07
Earnings (loss) per common share - diluted	0.06	0.03	(0.01)	(0.03)	0.03	0.00	(0.02)	(0.01)	0.06

There was no income or loss caused by discontinued operations and/or extraordinary items.

Substantially all of the Company's revenue is from the sale of COLD-FX. Sales of this product exhibit a seasonal pattern tied to the frequency and severity of colds and flu. Consumer purchases are affected by factors that also include the weather. This affects the volume and timing of sales. The fourth quarter of the Company's fiscal year corresponds to the time that most of the Company's major customers commence stocking up on cold and flu products in anticipation of demand in the late fall and winter months when, historically, the incidence of colds and flu rises. Further orders are made for restocking of product once the cold and flu season commences, which typically corresponds to the Company's first quarter. The Company's second quarter corresponds to the time that the incidence of colds and flu are on the decline. The third quarter is historically the quarter with the lowest revenue as the incidence of colds and flu is typically at its lowest. The Company aims to time marketing expenditures with anticipated increase in cold and flu activity; however, depending on specific marketing programs, these expenditures may not fall within the quarters for which revenue is derived. Management believes that many of the Company's retail customers reduced levels of store inventories when faced with uncertain economic conditions, which was reported widely in the media during the Company's second quarter of fiscal 2009 and, as a result, lower revenue was achieved resulting in a higher than expected loss for that quarter. Public awareness of flu increased with an increase in the incidence of flu and the associated World Health Organization announcement, and media coverage thereon, of a pandemic strain of the flu. Revenue and net earnings increased in the Company's third and fourth quarters of fiscal 2009 and the first quarter of fiscal 2010 as compared to the corresponding prior year's quarters as a result of an increase in demand for COLD-FX during this period.

### **LIQUIDITY AND CAPITAL RESOURCES**

The Company's main source of capital in the most recently completed quarter was the use of the Company's cash on hand built up through operating activities in prior periods. The Company's \$5 million operating line of credit was not utilized in the period. The Company's primary use of cash is for the funding of operating activities; however, in the first quarter of 2010, due to the seasonal nature of the sale of the Company's major product, cash was generated from operating activities as inventories were reduced upon sale of product and receivables collected. In addition to supporting operating activities, capital was used in the quarter to finance capital expenditures and make principal payments on long-term debt. On an annual basis, the Company's main source of capital was also from the use of the Company's cash on hand built up through operating activities in prior periods. The primary uses of cash are the financing of working capital, capital expenditures and the repurchase of shares under a normal course issuer bid.

The Company's first and fourth quarters historically generate higher revenue due to the seasonality of sales of its main product, COLD-FX. Cash flow fluctuates because of cash out-flow requirements for inventory production, with higher activity in the third quarter required to build up inventories prior to the cold and flu season. Cash in-flows from the collection of receivables are higher in the first and second quarter as customers pay for invoices issued in the previous months' peak sale periods.

The Company's working capital and capital expenditure requirements depend upon numerous other factors including, but not limited to, the success and timing of the introduction of new products or entry into new markets, consumer demand, rights of return held by customers, timing of market development programs, and long-term focus on product research and development activities. The Company anticipates that cash generated from operations and availability of its bank operating line will be sufficient to meet its cash requirements beyond the next twelve months.

## Management's Discussion and Analysis *(continued)*

### Selected cash flow and capitalization data

*(in thousands)*

	First quarter ended December 31, 2009	First quarter ended December 31, 2008
Cash flow prior to working capital changes <sup>1</sup>	\$6,979	\$2,856
Cash provided by operating activities	13,327	4,900
	As at December 31, 2009	As at September 30, 2009
Cash and cash equivalents	\$16,219	\$3,495
Working capital <sup>1</sup>	21,878	15,135
Long-term debt and obligations under capital lease (including current portion)	6,207	6,359

<sup>1</sup> Cash flow prior to working capital changes and working capital are non-GAAP measures and may not be comparable to similar measures presented by other issuers. Reconciliations of these measures to the most directly comparable financial measure calculated and presented in accordance with GAAP along with explanations as to why they are used is provided in the "Non-GAAP Financial Measures and Reconciliations" section.

### Cash and working capital

At December 31, 2009, the Company had \$16.2 million of cash and cash equivalents on hand. This compares to \$3.5 million in cash and cash equivalents for the year ended September 30, 2009. The Company's working capital at December 31, 2009 was \$21.8 million (September 30, 2009 - \$15.1 million). The increase in cash and working capital is primarily due to an increase in cash flow provided by operating activities generated by strong first quarter revenue.

### Cash provided by operating activities

Cash flow prior to working capital changes of \$7.0 million for the first quarter of fiscal 2010 increased \$4.1 million from the amount in the first quarter of fiscal 2009 primarily due to the higher revenue and a resulting higher net earnings. Cash provided by operating activities for the three month period ended December 31, 2009 was \$13.3 million compared to \$4.9 million for the same period in fiscal 2009. The increase in cash provided by operating activities is also due to higher net earnings and due to a decrease in non-cash working capital. This decrease in non-cash working capital is a result of the following: an increase in accounts payable due to timing of funding of customer trade promotions and the timing of paying trade accounts payable invoices; a net tax payable balance rather than a net tax receivable balance as tax instalment requirements in the first quarter were less than the tax provisions made in the quarter; and a decrease in inventory based on strong first quarter shipments. Despite a cash balance increase due to the collection of receivables for sales made in the first quarter as well as for the collection of prior quarter invoices, an increase in accounts receivable occurred due to higher product shipments in the quarter. This increase in accounts receivable partially offset the non-cash working capital decrease.

### Cash flow used in investing activities

Capital expenditures on property and equipment for the first quarter of fiscal 2010 of \$0.3 million are primarily for additional lab equipment for the Company's corporate office and research facility and for leasehold improvements. Leasehold improvements were incurred upon the relocation of the Company's sales and marketing offices in Ontario. Purchases of intangible assets of \$0.1 million in the quarter relate primarily to legal costs associated with the filing of new patents and trademarks. Capital expenditures in the first quarter of fiscal 2009 were of a similar nature except no leasehold improvement expenditures were made in that quarter.

### Cash flow from financing activities

During the first quarter of fiscal 2010, financing activities were primarily limited to \$176 thousand in long-term debt repayments and a \$30 thousand repurchase of Company shares through a normal course issuer bid. During the first quarter of fiscal 2009, financing activities were primarily limited to term debt repayments.

### **Capital requirements and capitalization**

At December 31, 2009, the Company had obligations to repay within one year \$0.7 million of long-term debt and obligations under capital leases and make \$2.4 million of payments under operating lease agreements for premises and sponsorships. The Company projects capital expenditures in fiscal 2010 to be approximately \$1.4 million consisting of lab, office and computer equipment. Also included in this total are leasehold improvement costs for the relocation of the Company's sales and marketing office to a new location in the first quarter of 2010 as well as an estimate of additional capitalized patent and trademark costs. The projected amount is contingent on the hiring of personnel for whom some of the equipment is forecasted to be purchased and the Company's progress with research and development for which patents and trademarks are expected to be filed, therefore, the actual 2010 fiscal expenditures may vary from the Company's forecast.

### **Aggregate contractual obligations and off-balance sheet financing**

Long-term debt primarily consists of a three year term mortgage facility related to the Company's Edmonton, Alberta facility. The Company may repay the mortgage at any time in whole or in part, subject to a three month interest penalty. The Company also has a capital lease related to land on which the Company's Edmonton, Alberta facilities are located. The capital lease expires on November 15, 2015, and the Company expects to exercise its option to purchase the land at that time.

The Company has entered into operating and capital lease and purchasing agreements in the ordinary course of its business. In addition, the Company has entered into various agreements to provide financial assistance in research and development activities and clinical studies. On January 20, 2009, the Company entered into an agreement with the Vancouver Organizing Committee ("VANOC") for the 2010 Olympic and Paralympic Winter Games. The agreement provides the Company exclusive sponsorship rights in Canada in the "Over the Counter Cold and Flu Remedy" product category. The Company will expense fees for these sponsorship rights as incurred.

### **Class action lawsuit**

On September 16, 2009, the Company announced it had reached an agreement in principle, subject to court approval, to settle two proposed class action lawsuits that were commenced in August 2007. The agreement in principle provides for the settlement, release and dismissal of all claims asserted against the Company, its former auditor and the individual proposed defendants. The Company's anticipated contribution to the settlement amount is to be funded through its insurance coverage. The agreement in principle remains subject to final settlement documents and receipt of court approval. The settlement does not constitute any admission of liability by the Company or its officers, directors and employees.

### **Related party transactions**

No related party transactions with new related parties have been entered into during the Company's first three months of fiscal 2010. Further discussion regarding related party transactions can be found in the Company's September 30, 2009 Management's Discussion and Analysis.

### **Outstanding shares, stock options, deferred share units, and restricted share units.**

The Company is authorized to issue an unlimited number of common shares and an unlimited number of preferred shares. As at February 10, 2010, 104,872,012 common shares were outstanding as compared to 104,912,918 at September 30, 2009. No preferred shares were outstanding during or at the end of these periods.

The pool of options available for grants at February 10, 2010 was 8,821,450. On January 21, 2009, the Company's Board of Directors approved amendments to 2,050,000 options to remove performance-based vesting provisions.

As at February 10, 2010 the Company has outstanding 173,322 deferred share units and 175,000 restricted share units of which 40,473 of the deferred share units were granted in the first quarter of fiscal 2010.

### **Normal course issuer bid**

On October 14, 2009, the Company announced that it had renewed its normal course issuer bid ("NCIB") with the Toronto Stock Exchange. The Company is entitled to repurchase up to 5,245,645 of the Company's common shares, representing 5% of its then issued and outstanding common shares. The NCIB commenced on October 16, 2009 and will terminate on October 15, 2010. Under this NCIB, Afexa repurchased 40,906 common shares at a weighted average trading price of \$0.73 per share. The repurchased shares were cancelled prior to December 31, 2009.

### **OUTLOOK**

February 2010 will be an important month for winter sports in Canada and for Afexa as an official sponsor of the 2010 Winter Olympic Games. The Company will continue to develop its COLD-FX brand during the Games, with a multitude of events planned in and around the games. The Company has already supplied COLD-FX to VANOC for distribution to all of the Vancouver Olympic volunteers as well as supplying product to Canada Ski Cross, Canada Alpine Ski and all seven of the Canadian Sports Centres to work towards having the best and healthiest games ever. Afexa is also now able to promote IMMUNITY-FX as an official sponsored product. During the games, the Company will be distributing COLD-FX and IMMUNITY-FX to close to a quarter of a million spectators in venues throughout Vancouver and across Canada to strengthen the COLD-FX brand and to raise awareness of our new brand, IMMUNITY-FX. Donations received by Afexa for providing the product will be directed to Canadian Athletes through the Canadian Olympic foundation.

Afexa is proud of its association with the 2010 Olympic Games and Canadian Olympians and is in line with its vision of delivering the most trusted health brand on the planet. The Company has received NSF certification on its COLD-FX brand.

IMMUNITY-FX, launched by the Company in the fourth quarter of fiscal 2009, is now on the shelves of leading pharmacies, retailers and natural health products stores across Canada. In line with our revenue recognition policy, IMMUNITY-FX revenue is only recorded as consumers make purchases from retailers. The Company will maintain this approach until the brand is firmly established.

The Company expects a moderation in customer orders in the Company's second quarter of fiscal 2010 as Afexa's retail customers become well supplied with cold and flu products and consumer purchases slow based on an expected lower incidence of colds and flu in this period. The Company monitors the incidence of colds and flu through commissioned third-party data and the most recent reports show that the current incidence of colds and flu is below the three year average.

Scientific and clinical research is at the core of our Company's vision. The Company will be increasing spending for further research and development of new products, including clinical trials. Clinical studies are examining the possible application of CVT-E002, the core active ingredient in COLD-FX and IMMUNITY-FX, in immune-related diseases such as seasonal allergic rhinitis and cancer. Trials under way include a United States National Cancer Institute approved multi-centre study, which continues to be in the analysis phase, on the safety and efficacy of COLD-FX for preventing colds and flu and strengthening immune systems in patients with chronic lymphocytic leukemia. Other studies are investigating the core active ingredient in REMEMBER-FX® and MEMORY-FX® in healthy aging adults, and the application of new formulations in metabolic syndrome, particularly cholesterol and blood sugar management. In addition, a pilot clinical trial of LIP-01, an ingredient that has shown promise in reducing harmful blood lipids, including LDL cholesterol, is underway. The trial is designed to identify optimum dosing levels. Afexa's preclinical studies, although early, indicate that LIP-01 may have potential to prevent and manage diseases associated with high cholesterol. A full international patent application has been filed to protect LIP-01's composition, manufacturing process, and therapeutic use.

Canada remains the engine of the Company's business and showcase for Afexa products. The Company's strategic plan also contemplates other potential growth initiatives, such as acquisitions, strategic partnerships, and international licensing agreements. The Company's management team will continue to evaluate these initiatives as potential drivers of Afexa's long-term success, including the potential of seeking botanical drug registration for COLD-FX in the United States. This would allow us to make further claims regarding our product's efficacy for colds and flu and would potentially benefit the Company's ability to market its products elsewhere in the world.

### **DISCLOSURE CONTROLS AND PROCEDURES ("DC&P") AND INTERNAL CONTROLS OVER FINANCIAL REPORTING ("ICFR")**

Management has evaluated whether there were changes in the Company's internal controls over disclosure and financial reporting during the most recent interim period ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect the Company's DC&P and ICFR. No material changes were identified for the period.

The Company continues to work on implementing control enhancements to address the weaknesses described in the Company's 2009 year-end Management's Discussion and Analysis, including the implementation of a trade promotion management application which is scheduled to be completed by the end of the second quarter. The implementation of both this software application and improved estimation processes will enhance the Company's ability to compute and review certain management estimates related to revenue.

As these control enhancements have not yet been fully implemented, management has concluded that disclosure controls and procedures, and internal controls over financial reporting are ineffective. Throughout the period, management has continued to implement manual review processes to minimize the risk of error to an acceptable level.

In addition, the Company continues to enhance its oversight function and reported that Mr. Jack Moffatt joined the Board as Executive Chair, and assumed interim oversight responsibility for operations of the Company, effective October 1, 2008. He assumed responsibility as Chairman and Chief Executive Officer, effective December 10, 2009. Also, on November 24, 2009, Mr. John Rogers and Mr. William White joined Afexa's Board of Directors and subsequently joined the Company's audit committee to fill vacancies from departures of previous Board members.

Material misstatements due to error or fraud may not always be prevented or detected on a timely basis because of the inherent limitation of DC&P and ICFR, including the possibility of collusion or improper management override of controls. Inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes. In addition, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Management will continue to monitor and improve internal controls as necessary and appropriate for the business. Further discussion regarding DC&P and ICFR can be found in the Company's September 30, 2009 year-end Management's Discussion and Analysis.

### **RISKS AND UNCERTAINTIES**

The Company's results are affected by: financial risks (including liquidity, interest rate, foreign exchange, credit and litigation risks); operational risks (market and product, seasonality of demand, product development, material supply and reliance on third party risks); regulatory approvals and health and safety risks.

The Company takes a proactive approach in the identification and management of risks, including review of such risks through compliance reviews and oversight by the Board's Audit Committee. Mitigation of these risks include, but are not limited to, credit policies, operational policies, maintaining adequate insurance, as well as policies and enforcement procedures that can affect the Company's reputation.

As discussed in the 2009 year-end Management's Discussion and Analysis, management continues to believe that the Company remains in its growth stage with its lead product COLD-FX; however, customer demand is at risk with changes in economic activity and with the seasonal variations in the incidence of colds and flu. The Company is dependent on a few retail customers for the majority of its revenue. Declining demand from any one of these retail customers will have a negative impact on the Company's revenues and cash flows. To mitigate this risk, and to ensure the Company continues to increase its market share, the Company will continue to pursue its marketing, advertising and public awareness programs to increase end-consumer demand.

The Company's dependence on a few retail customers for a majority of its revenue also increases counterparty risk. This risk is mitigated by the Company's customer mix, which is comprised of large retailers, and by the Company's credit risk management processes. Management believes that the Company's current cash position is adequate to mitigate potential tightening of credit terms, while meeting its near term obligations and also believes that its current credit line limits are sufficient to meet the cash flow requirements of its seasonal operations.

Subsequent to the end of the quarter, the National Association of Pharmacy Regulatory Authorities ("NAPRA") issued a statement of position on Health Canada's Natural Health Products Regulations. These regulations came into effect in 2004 and included a requirement for all natural health products to obtain a license or Natural Product Number ("NPN"). The statement of position issued in January 2010 by NAPRA provides guidance that pharmacists should not sell a natural health product without a NPN. This is contrary to the position taken by Health Canada which indicates that natural health products will not be subjected to compliance action due to the lack of a NPN as long as they have applied for one. This policy was developed in recognition of a NPN application backlog at Health Canada and following extensive consultation with various stakeholders, including industry and pharmacists. The Company already holds NPNs for its main revenue generating product, COLD-FX, and has submitted applications for all other products it sells, including IMMUNITY-FX. The backlog of applications at Health Canada may result in some delays in processing applications. Any delay in receipt of a NPN can have a negative impact on the timing and brand development for existing and new products.

Further discussion regarding other risks and mitigation, thereof, can be found in the Company's September 30, 2009 Management's Discussion and Analysis and the Company's Annual Information Form available on SEDAR. Additional risks and uncertainties that the Company is unaware of or currently deems immaterial may subsequently become important factors, which may materially affect the business.

## **ACCOUNTING POLICIES AND ESTIMATES**

### **NEW ACCOUNTING STANDARDS ADOPTED**

The Company adopted the following new Canadian Institute of Chartered Accountants ("CICA") Handbook standards.

#### **Consolidated Financial Statements and Non-Controlling Interest**

In January 2009, the CICA issued Handbook Section 1601, Consolidated Financial Statements, and Handbook Section 1602, Non-Controlling Interest, which replaced existing standards. These sections carry forward existing Canadian guidance for preparing consolidated financial statements containing or excluding non-controlling interests. The sections are effective for interim and annual financial statements beginning on January 1, 2011 and earlier adoption is permitted. The Company has early adopted these standards and has concluded there is no material impact on its consolidated financial statements.

#### **Business Combinations**

In January 2009, the CICA issued Handbook Section 1582, Business Combinations, which replaces Section 1581, Business Combinations. It provides guidance on improving the relevance, reliability, and comparability of the information disclosed about a business combination and its effects. The section is applied prospectively for business combinations for which the

acquisition date is on or after the first annual reporting beginning on or after January 1, 2011 and earlier adoption is permitted. The Company has early adopted this standard and has concluded there is no material impact on its consolidated financial statements.

### **Financial Instrument – Disclosures**

In March 2009, the Canadian Accounting Standards Board announced it has agreed to adopt recent amendments to IFRS 7, Financial Instruments: Disclosures, into Section 3862, Financial Instruments – Disclosures. The amendments to Section 3862 will apply to annual financial statements for years ending after September 30, 2009. The amendments require that an entity disclose the classification, for each class of financial instrument, of fair value measurements within a fair value hierarchy. The hierarchy includes three levels: Level 1 – quoted prices in active markets, Level 2 – measurements determined using valuation models that employ observable inputs and Level 3 – measurements determined using valuation models that employ unobservable inputs. On October 1, 2009, the Company adopted this standard and has reflected the required changes to its disclosures in these consolidated financial statements.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

### **Convergence with International Financial Reporting Standards (“IFRS”)**

In February 2008, the CICA Accounting Standards Board (“AcSB”) confirmed that International Financial Reporting Standards will replace Canadian GAAP in 2011 for profit-oriented Canadian publicly accountable enterprises. As the Company will be required to report its results in accordance with IFRS commencing in its fiscal year ending September 30, 2012, the Company is assessing the potential impacts of this changeover and is developing a conversion plan which will include: a detailed timeline; further training and education requirements; and the impact on accounting policies, information systems, internal controls over financial reporting and business activities.

The Company has completed a high-level assessment of the significant differences between Canadian GAAP and IFRS specific to the Company. The Company also conducted initial IFRS awareness training for staff and continues to monitor AcSB's proposed changes to standards during Canada's transition to IFRS. These changes may have a significant impact on the Company's implementation plan and future financial statements.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Critical accounting policies and estimates are those policies, assumptions and estimates that are most important in the preparation of the Company's consolidated financial statements. The selection of policies requires management's subjective and complex judgment from many alternatives and estimates involving matters that are inherently uncertain. Those policies, assumptions and estimates affect the reported amounts of assets and liabilities and revenue and expenses during the period represented and at the date of the financial statements. Actual results could differ from these estimates.

Significant estimates made by management include provisions for customer discounts and incentives, allowances for uncollectible accounts, rights of return, the realizable portion of inventory during the Company's normal business cycle, inventory provisions, the realizing of future income taxes, useful lives of long-lived assets, future expected cash flows used in evaluating long-lived assets for impairment, percentage completion of contracted service expenditures and stock-based compensation fair values. Further discussion regarding critical accounting policies and estimates can be found in the Company's September 30, 2009 Management's Discussion and Analysis.

## **NON-GAAP FINANCIAL MEASURES AND RECONCILIATIONS**

Normally, a non-generally accepted accounting principle (“non-GAAP”) financial measure is a numerical measure of a company's performance, financial position or cash flow that either excludes or includes amounts not normally excluded

## Management's Discussion and Analysis *(continued)*

or included in the most directly comparable measure calculated and presented in accordance with GAAP. Working capital, EBITDA, and cash flow prior to working capital changes are not measures of financial performance (nor do they have standardized meanings) under GAAP. In evaluating these measures, investors should consider that the methodology applied in calculating such measures may differ among companies and analysts.

The Company uses both GAAP and certain non-GAAP measures to assess performance. Management believes these non-GAAP measures provide useful supplemental information to investors in order that they may evaluate the Company's financial performance using the same measures as management. The Company's management believes that, as a result, information provided to the investor is more transparent in assessing the financial performance of the Company. Investors should not consider these non-GAAP financial measures as a substitute or superior to the measures of financial performance prepared in accordance with GAAP.

### Working capital

The definition of working capital is current assets less current liabilities. The Company uses working capital as a supplemental financial measure of its liquidity and operational performance.

#### Working capital

*(in thousands)*

	As at December 31, 2009	As at September 30, 2009
Current assets	\$ 36,762	\$ 23,791
Current liabilities	14,884	8,656
Working capital	\$ 21,878	\$ 15,135

### EBITDA

EBITDA is defined as earnings before interest, income taxes, depreciation and amortization. The Company uses EBITDA as a supplemental financial measure of its operational performance. Management believes EBITDA to be an important measure as it excludes the effects of items that primarily reflect the impact of long-term investment decisions, rather than the performance of the Company's day-to-day operations and is used by the Company's lenders in computing certain covenants. As compared to net earnings according to GAAP, this measure is limited in that it does not reflect the periodic costs of certain capitalized tangible and intangible assets used in generating revenues in the Company's business. Management evaluates such items through other financial measures such as capital expenditures and cash flow provided by operating activities. The Company believes that this measurement is useful to assess a company's ability to service debt, to meet other payment obligations and as a valuation measurement.

The following is a reconciliation of EBITDA to net earnings, the most directly comparable financial measure calculated and presented in accordance with GAAP.

#### EBITDA

*(in thousands)*

	First quarter ended December 31, 2009	First quarter ended December 31, 2008
Net earnings	\$ 6,816	\$ 2,807
Current income taxes	3,359	1,826
Future income taxes	(324)	(299)
Amortization	340	313
Interest and bank charges	95	127
Interest revenue	(12)	(76)
EBITDA	\$ 10,274	\$ 4,698

## Management's Discussion and Analysis *(continued)*

### Cash flow prior to working capital changes

Below is a reconciliation of "cash flow prior to working capital changes" to cash provided by operating activities, the most directly comparable financial measure calculated and presented in accordance with GAAP.

The Company uses cash flow prior to working capital changes as a supplemental financial measure in its evaluation of liquidity. Management believes that adjusting principally for the swings in non-cash working capital items due to seasonality assists management in making long-term liquidity assessments. The Company also believes that this measurement is useful as a liquidity and valuation measurement.

### Cash flow prior to working capital changes

*(in thousands)*

	First quarter ended December 31, 2009	First quarter ended December 31, 2008
Cash provided by operating activities	\$ 13,327	\$ 4,900
Change in non-cash operating working capital	(6,348)	(2,004)
Change in non-current inventory	-	(40)
Cash flow prior to working capital changes	\$ 6,979	\$ 2,856

### Advisory Regarding Forward-looking Statements

Management's discussion and analysis contains certain forward-looking information and statements within the meaning of applicable securities laws. The forward-looking information and statements included in this MD&A are not guarantees of future performance and should not be unduly relied upon. Such information and statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking information or statements including, without limitation: those comments predicting the timing and/or initiation of clinical trials, clinical trial results, and associated regulatory clearances; initiatives to reduce time required to complete or start research projects and whether or not those projects will lead to commercialized products; whether LIP-01 will show efficacy leading to a commercialized product for cholesterol management; whether or not the Company decides to seek U.S. botanical drug registration and whether such application would lead to registration and if successful; whether such registration would lead to other market registrations; financing and acceptance of COLD-FX and other of the Company's products in the marketplace; U.S. revenue generation through internet channels; control initiatives to enhance management's ability to estimate revenue; Olympic sponsorship activities and whether or not these will lead to increased brand awareness and increased sales of COLD-FX and IMMUNITY-FX; consumer buying patterns and whether the product demand seen in the first quarter 2010 will continue; and comments related to potential growth through acquisitions, strategic partnerships and/or licensing activities. The use of any of the words "expect", "anticipate", "continue", "estimate", "objective", "ongoing", "may", "will", "would", "project", "could", "should", "contemplate", "potential", "depend", "forecast", "believe", "plans", "targets", "intends" and similar expressions are intended to identify forward-looking statements. In addition to the risks outlined in the Risks and Uncertainties section, this MD&A contains forward-looking information and statements pertaining to the following: the impact of competition; consumer confidence and spending levels; general economic conditions; interest and currency exchange rates; unseasonable weather patterns; the incidence of illnesses in the general population; the cost and availability of capital; the cost and availability of grants/funding; product development; lawsuit final settlement expectations; reliance on third parties; dependence on a small number of major customers; hiring expectations and related anticipated capital expenditures; adequate cash position to mitigate potential tightening of credit terms; success and adequacy of the IFRS conversion plan and the impact of the implementation on future financial statements; the risk that actual results may differ from management's assumptions, estimates and interpretation of policies; marketing efforts anticipated to parallel increases in cold and flu activity may not necessarily be accounted for in the quarters for which revenue is derived; and delays in receipt of a NPN for IMMUNITY-FX may potentially have a negative impact on the business and future development plans. The Company believes that the expectations and assumptions reflected in the forward-looking information and statements contained herein are reasonable but no assurance can be given that these expectations and assumptions are correct and that the results, performance or achievements 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. All forward-looking statements are expressly qualified in their entirety by this cautionary statement.

The forward-looking information and statements contained in this MD&A speak only as at the date of this MD&A, and none of the Company or its subsidiaries assumes any obligation to publicly update or revise them to reflect new events or circumstances, except as may be required pursuant to applicable laws.