

METHES ENERGIES INTERNATIONAL LTD  
Form 10-Q  
July 15, 2013

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the Quarterly Period Ended May 31, 2013

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

Commission File Number 001-35652

METHES ENERGIES INTERNATIONAL LTD.  
(Exact name of registrant as specified in its charter)

NEVADA 71-1035154  
(State of (I.R.S.  
other Employer  
jurisdiction of Identification  
incorporation No.)  
or  
organization)

3651 Lindell Road, Suite D-272, Las Vegas, Nevada, 89103  
(Address of principal executive offices)

(702) 932-9964  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data file required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act:

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

As of July 12, 2013, the registrant has 6,978,169 shares of Common Stock issued and outstanding.

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METHES ENERGIES INTERNATIONAL LTD.

FORM 10-Q

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## CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

This Form 10-Q contains “forward looking information” within the meaning of applicable securities laws. Such statements include, but are not limited to, statements with respect to the Company’s beliefs, plans, strategies, objectives, goals and expectations, including expectations about the future financial or operating performance of the Company and its projects, capital expenditures, capital needs, government regulation of the industry, environmental risks, limitations of insurance coverage, and the timing and possible outcome of regulatory matters, including the granting of patents and permits. Words such as “expect,” “anticipate,” “intend,” “attempt,” “may,” “will,” “plan,” “believe,” “s” “estimate” and variations of such words and similar expressions are intended to identify such forward looking information. These statements are not guarantees of future performance and involve assumptions, risks and uncertainties that are difficult to predict.

These statements are based on and were developed using a number of factors and assumptions including, but not limited to: stability in the U.S. and other foreign economies; stability in the availability and pricing of raw materials, energy and supplies; stability in the competitive environment; the continued ability of the Company to access cost effective capital when needed; and no unexpected or unforeseen events occurring that would materially alter the Company’s current plans. All of these assumptions have been derived from information currently available to the Company including information obtained by the Company from third party sources. Although management believes that these assumptions are reasonable, these assumptions may prove to be incorrect in whole or in part. As a result of these and other factors, actual results may differ materially from those expressed, implied or forecasted in such forward looking information, which reflect the Company’s expectations only as of the date hereof.

Factors that could cause actual results or outcomes to differ materially from the results expressed, implied or forecasted by the forward-looking information include risks associated with general business, economic, competitive, political and social uncertainties; risks associated with changes in project parameters as plans continue to be refined; risks associated with failure of plant, equipment or processes to operate as anticipated; risks associated with accidents or labour disputes; risks associated in delays in obtaining governmental approvals or financing, or in the completion of development or construction activities; risks associated with financial leverage and the availability of capital; risks associated with the price of commodities and the inability of the Company to control commodity prices; risks associated with the regulatory environment within which the Company operates; risks associated with litigation including the availability of insurance; and risks posed by competition. These and other factors that could cause actual results or outcomes to differ materially from the results expressed, implied or forecasted by the forward looking information are discussed in more detail in Item 1A under “Risk Factors” in Part I of our Annual Report on Form 10-K for the fiscal year ended November 30, 2012, as may be supplemented or amended from time to time and in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Part I, Item 2 in this document.

The Company does not intend to, and the Company disclaims any obligation to, update any forward-looking information (including any financial outlooks), whether written or oral, or whether as a result of new information, future events or otherwise, except as required by law.

All references in this Form 10-Q to “Company,” “Methes,” “we,” “us,” or “our” refer to Methes Energies International Ltd. and its wholly owned subsidiaries Methes Energies Canada Inc. and Methes Energies USA Ltd. unless the context otherwise indicates.

We have rights to the trademarks Methes Energies and Design, Methes, The Biodiesel Company and Denami.



## PART I. FINANCIAL INFORMATION

## ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## METHES ENERGIES INTERNATIONAL LTD.

CONDENSED CONSOLIDATED BALANCE SHEETS AS OF NOVEMBER 30, 2012 AND MAY 31, 2013  
(EXPRESSED IN US\$)

|   | November 30,<br>2012<br>(Unaudited) | May 31,<br>2013<br>(Unaudited) |
|---|-------------------------------------|--------------------------------|
| <b>ASSETS</b>   |                                     |                                |
| Current assets  |                                     |                                |
| Cash and cash equivalents   | \$ 402,724                          | \$ 188,486                     |
| Accounts receivable, net (notes 9 and 11)   | 303,418                             | 416,850                        |
| Inventories (note 3)  | 1,196,798                           | 1,099,625                      |
| Prepaid expenses and deposits   | 100,972                             | 97,545                         |
| Deferred financing fees   | 26,334                              | 3,751                          |
| <b>Total current assets</b>   | <b>2,030,246</b>                    | <b>1,806,257</b>               |
| Deposits and employee loans   | 13,813                              | 32,996                         |
| Property, plant and equipment, net (note 4)   | 8,231,826                           | 8,350,060                      |
| Intangible assets, net  | 413,027                             | 403,117                        |
| <b>Total assets</b>   | <b>\$ 10,688,912</b>                | <b>\$ 10,592,430</b>           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                                     |                                |
| Current liabilities   |                                     |                                |
| Accounts payable (note 9)   | \$ 1,247,459                        | \$ 1,429,470                   |
| Accrued liabilities   | 515,207                             | 773,328                        |
| Payable to related parties and others (note 5)  | 1,617,999                           | 2,194,980                      |
| Short-term loans (note 6)   | 1,509,600                           | 1,843,126                      |
| <b>Total liabilities</b>  | <b>4,890,265</b>                    | <b>6,240,904</b>               |
| Stockholders' equity  |                                     |                                |
| Preferred stock, \$0.001 par value, 10,000,000 shares authorized;<br>no shares issued or outstanding at November 30, 2012 and<br>May 31, 2013, respectively (note 7)                    | —                                   | —                              |
| Common stock, \$0.001 par value, 75,000,000 shares authorized;<br>6,553,169 and 6,978,169 shares issued and outstanding at<br>November 30, 2012 and May 31, 2013, respectively (note 7) | 6,553                               | 6,978                          |
| Additional paid-in capital  | 16,033,123                          | 17,468,720                     |
| Accumulated deficit   | (10,241,029)                        | (13,124,172)                   |
| <b>Total stockholders' equity</b>   | <b>5,798,647</b>                    | <b>4,351,526</b>               |

|  |               |               |
|--|---------------|---------------|
| Total liabilities and stockholders' equity | \$ 10,688,912 | \$ 10,592,430 |
|--|---------------|---------------|

Commitments (note 10)

See accompanying notes to unaudited condensed consolidated financial statements

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## METHES ENERGIES INTERNATIONAL LTD.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)  
FOR THE THREE AND SIX MONTHS ENDED MAY 31, 2012 AND 2013  
(EXPRESSED IN US\$)

|   | Three<br>Months<br>Ended<br>May 31,<br>2012 | Three<br>Months<br>Ended<br>May 31,<br>2013 | Six Months<br>Ended<br>May 31,<br>2012 | Six Months<br>Ended<br>May 31,<br>2013 |
|---|---|---|--|--|
| Revenue   |   |   |  |  |
| Biodiesel sales   | \$1,764,097                                 | \$2,080,304                                 | \$4,314,989                            | \$2,210,740                            |
| Feedstock sales   | 49,213                                      | 40,802                                      | 283,961                                | 84,988                                 |
| Glycerin sales  | 21,098                                      | 22,635                                      | 49,767                                 | 36,441                                 |
| Government incentives (note 11)                                 | 150,440                                     | 170,124                                     | 244,456                                | 179,004                                |
| Equipment sales   | 7,592                                       | 2,657                                       | 16,500                                 | 2,657                                  |
| Royalties   | 9,597                                       | 2,793                                       | 44,279                                 | 6,775                                  |
| Others  | 80,186                                      | 9,039                                       | 110,448                                | 17,860                                 |
|   | 2,082,223                                   | 2,328,354                                   | 5,064,400                              | 2,538,465                              |
| Cost of goods sold  | 1,681,147                                   | 2,221,184                                   | 4,438,052                              | 2,410,713                              |
| Gross profit  | 401,076                                     | 107,170                                     | 626,348                                | 127,752                                |
| Operating expenses  |   |   |  |  |
| Selling, general and administrative<br>expenses (notes 4 and 8) | 957,510                                     | 1,476,838                                   | 1,807,435                              | 2,767,926                              |
| Loss before interest and taxes                                  | (556,434 )                                  | (1,369,668 )                                | (1,181,087 )                           | (2,640,174 )                           |
| Other expenses  |   |   |  |  |
| Interest expense (notes 5 and 6)                                | (22,261 )                                   | (122,143 )                                  | (31,448 )                              | (242,969 )                             |
| Loss before income taxes  | (578,695 )                                  | (1,491,811 )                                | (1,212,535 )                           | (2,883,143 )                           |
| Income taxes  | —   | —   | —                                      | —                                      |
| Net loss for the period   | \$(578,695 )                                | \$(1,491,811 )                              | \$(1,212,535 )                         | \$(2,883,143 )                         |
| Net Loss Per Common Share - Basic and Diluted                   | \$(0.10 )                                   | \$(0.21 )                                   | \$(0.21 )                              | \$(0.42 )                              |
| Weighted average number of common shares -<br>Basic and Diluted | 5,841,547                                   | 6,978,169                                   | 5,823,765                              | 6,790,324                              |

See accompanying notes to unaudited condensed consolidated financial statements



## METHES ENERGIES INTERNATIONAL LTD.

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (Unaudited)  
FOR THE SIX MONTHS ENDED MAY 31, 2012 AND 2013  
(EXPRESSED IN US\$)

|  | Common Stock<br>Shares | Common Stock<br>Amount | Additional<br>Paid-in<br>Capital | Subscription<br>Receivable | Accumulated<br>Deficit | Total<br>Stockholders'<br>Equity |
|--|------------------------|------------------------|----------------------------------|----------------------------|------------------------|----------------------------------|
| Balance at November 30,<br>2011              | 5,734,447              | \$ 5,734               | \$ 11,598,421                    | \$ (46,056)                | \$ (6,274,264)         | \$ 5,283,835                     |
| Issuance of common stock<br>for cash         | 211,787                | 212                    | 1,624,838                        | —                          | —                      | 1,625,050                        |
| Common stock to be issued                    | —                      | —                      | 100,000                          | —                          | —                      | 100,000                          |
| Stock-based compensation                     | —                      | —                      | 122,567                          | —                          | —                      | 122,567                          |
| Stock subscription                           | —                      | —                      | —                                | 46,056                     | —                      | 46,056                           |
| Net loss for the period                      | —                      | —                      | —                                | —                          | (1,212,535)            | (1,212,535)                      |
| Balance at May 31, 2012                      | 5,946,234              | \$ 5,946               | \$ 13,445,826                    | \$ —                       | \$ (7,486,799)         | \$ 5,964,973                     |
| Issuance of common stock<br>for cash         | 46,935                 | 47                     | 259,954                          | —                          | —                      | 260,001                          |
| Issuance of units - IPO                      | 560,000                | 560                    | 2,799,440                        | —                          | —                      | 2,800,000                        |
| IPO issuance cost                            | —                      | —                      | (996,477)                        | —                          | —                      | (996,477)                        |
| Stock-based compensation                     | —                      | —                      | 124,382                          | —                          | —                      | 124,382                          |
| Penalty shares (note 7)                      | —                      | —                      | 399,998                          | —                          | —                      | 399,998                          |
| Net loss for the period                      | —                      | —                      | —                                | —                          | (2,754,230)            | (2,754,230)                      |
| Balance at November 30,<br>2012              | 6,553,169              | \$ 6,553               | \$ 16,033,123                    | \$ —                       | \$ (10,241,029)        | \$ 5,798,647                     |
| Issuance of units under<br>private placement | 425,000                | 425                    | 1,699,575                        | —                          | —                      | 1,700,000                        |
| Issuance cost                                | —                      | —                      | (330,610)                        | —                          | —                      | (330,610)                        |
| Stock-based compensation                     | —                      | —                      | 66,632                           | —                          | —                      | 66,632                           |
| Net loss for the period                      | —                      | —                      | —                                | —                          | (2,883,143)            | (2,883,143)                      |
| Balance at May 31, 2013                      | 6,978,169              | \$ 6,978               | \$ 17,468,720                    | \$ —                       | \$ (13,124,172)        | \$ 4,351,526                     |

See accompanying notes to unaudited condensed consolidated financial statements

## METHES ENERGIES INTERNATIONAL LTD.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)  
FOR THE SIX MONTHS ENDED MAY 31, 2012 AND 2013  
(EXPRESSED IN US\$)

|  | Six Months<br>Ended<br>May 31,<br>2012 | Six Months<br>Ended<br>May 31,<br>2013 |
|--|--|--|
| Cash flow from operating activities:                             |  |  |
| Net loss for the period  | \$ (1,212,535)                         | \$ (2,883,143)                         |
| Adjustments to reconcile net loss to net cash used in operations |  |  |
| Depreciation and amortization                                    | 107,758                                | 243,695                                |
| Non-cash stock-based compensation                                | 122,567                                | 66,633                                 |
| Unrealized foreign exchange gain                                 | —                                      | (76,193)                               |
| Deferred financing fees  | —                                      | 22,583                                 |
| Accrued interest expense   | —                                      | 81,641                                 |
| Changes in operating assets and liabilities:                     |  |  |
| Accounts receivable  | 754,016                                | (113,432)                              |
| Inventories  | 534,724                                | 97,173                                 |
| Prepaid expenses and deposits                                    | 23,099                                 | (15,756)                               |
| Accounts payable and accrued liabilities                         | (370,316)                              | 440,132                                |
| Net cash used in operating activities                            | (40,687)                               | (2,136,667)                            |
| Cash flow from investing activities:                             |  |  |
| Additions to property, plant and equipment                       | (3,812,731)                            | (351,828)                              |
| Additions to intangible assets                                   | —                                      | (191)                                  |
| Net cash used in investing activities                            | (3,812,731)                            | (352,019)                              |
| Cash flow from financing activities:                             |  |  |
| Payable to related parties and others                            | 1,031,118                              | 519,258                                |
| Short-term loans   | —                                      | 385,800                                |
| Deferred financing fees  | (131,756)                              | —                                      |
| Issuance of common stock/units, net of issuance costs            | 1,771,106                              | 1,369,390                              |
| Net cash provided by financing activities                        | 2,670,468                              | 2,274,448                              |
| DECREASE IN CASH AND CASH EQUIVALENTS                            | (1,182,950)                            | (214,238)                              |
| Cash and cash equivalents, beginning of period                   | 1,693,301                              | 402,724                                |
| CASH AND CASH EQUIVALENTS, END OF PERIOD                         | \$ 510,351                             | \$ 188,486                             |
| Supplemental disclosures of cash flow information                |  |  |
| Cash paid during period for:                                     |  |  |
| Interest   | \$ 1,054                               | \$ 171,723                             |

See accompanying notes to unaudited condensed consolidated financial statements.



METHES ENERGIES INTERNATIONAL LTD.  
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Unaudited  
As of May 31, 2013  
(Expressed in US\$)

NOTE 1 - NATURE OF THE BUSINESS, FINANCING REQUIREMENTS AND BASIS OF PRESENTATION

Methes Energies International Ltd. ("Methes" or the "Company"), was incorporated on June 27, 2007 in the State of Nevada. Methes, through its operations in Canada and the United States, is a biodiesel processing equipment provider and a biodiesel producer. The Company has developed biodiesel processing equipment to produce biodiesel from recycled oils. The Company, through its wholly-owned subsidiary Methes Energies Canada Inc. ("Methes Canada"), operates one biodiesel facility in Mississauga, Ontario with a total of 1.3 million gallons per year (mmgy) of nameplate production capacity and has commissioned a 13.0 mmgy production facility in Sombra, Ontario. In addition to Methes Canada, Methes Energies USA Ltd. ("Methes USA") was incorporated as the wholly-owned subsidiary of the Company on June 27, 2007. All references in this Form 10-Q to "Company," "Methes," "we," "us," or "our" refer to Methes Energies International Ltd. and its wholly owned subsidiaries Methes Canada and Methes USA unless the context otherwise indicates.

On October 4, 2012, Methes Canada was approved by the U.S. Environmental Protection Agency ("EPA") as a Foreign Renewable Fuel Producer at its Sombra, Ontario plant. As a result the biodiesel produced at this facility became eligible for export to the United States. Obtaining this approval from the EPA enables the Company to sell its biodiesel into the U.S., and provides its U.S. importers the ability to generate Renewable Identification Numbers ("RINs"). RINs are used in the U.S. by obligated parties to comply with certain obligations under the Renewable Fuel Standard 2 ("RFS2").

On October 12, 2012, the Company's registration statement on Form S-1 (File No. 333-182302) for its initial public offering ("IPO") was declared effective by the U.S. Securities and Exchange Commission ("SEC"). On October 30, 2012, the Company consummated the IPO pursuant to which it sold 560,000 units (each a "Unit") at a price \$5.00 per Unit, and raised net proceeds of approximately \$1.8 million, after deducting the underwriting discount and estimated offering expenses. Each Unit consists of (i) one share of common stock, \$.001 par value ("Common Stock"), (ii) one Class A warrant, to purchase one share of Common Stock at an exercise price of \$7.50 (each a "Class A Warrant"), and (iii) one Class B warrant, to purchase one share of Common Stock at an exercise price of \$10.00 (each a "Class B Warrant").

The Units were listed on the NASDAQ Capital Market under the symbol "MEILU". Until November 26, 2012, only the Units were traded. On November 26, 2012, the Units ceased trading and were subsequently delisted and the Common Stock, Class A Warrant and Class B Warrant began trading separately under the symbols MEIL, MEILW and MEILZ, respectively.

On February 19, 2013, the Company issued 425,000 Units to accredited investors at a price of \$4.00 per unit under a private placement and raised net proceeds of approximately \$1.4 million, after deducting the sales commission and fees. Each unit consists of one share of Common Stock, one Class A Warrant and one Class B Warrant, identical to the securities issued under the IPO. Each Class A and Class B warrant is exercisable to purchase one share of Common Stock at \$7.50 and \$10.00, respectively, and expires on October 12, 2017 (the "February 2013 Private Placement").

As at May 31, 2013, due in large part to the funds spent to develop, build and commission the Sombra facility as well as minimal sales of biodiesel, the Company had a working capital deficiency of \$4,434,647. During the six months ended May 31, 2013, the Company incurred a loss of \$2,883,143 and had negative cash flow from operations of

\$2,136,667. The Company anticipates that its Sombra facility will generate positive cash flow from operations and will operate profitably once sufficient level of commercial operation is achieved in the second half of the current fiscal year. However, in order to meet its development goals and ongoing operational requirements, the Company will require additional financing in the foreseeable future. It is management's opinion that its cash and cash equivalents, the anticipated positive cash flow from operations and cash from additional loans, including the Term Loan Facility disclosed in Note 13 - Subsequent Events, as well as private financing which is currently under negotiations, will be sufficient to meet the Company's cash requirements for at least the next 12 months.

The condensed consolidated financial statements have been prepared by the Company without audit, pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted as permitted by such rules and regulations. All adjustments, consisting of normal recurring adjustments, have been included. Management believes that the disclosures are adequate to present fairly the financial position, results of operations and cash flows at the dates and for the periods presented. It is suggested that these unaudited interim condensed consolidated financial statements be read in conjunction with the consolidated financial statements and the notes thereto appearing in the Company's latest annual report on Form 10-K. Results for interim periods are not necessarily indicative of those to be expected for the full fiscal year.

## NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Consolidation

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries Methes Canada and Methes USA. All significant inter-company transactions and balances have been eliminated.

### Deferred Financing Fees

Costs directly incurred in connection with the IPO were recorded as deferred financing fees until the completion of the IPO. These deferred financing fees were charged against additional paid-in capital upon completion of the IPO. Financing fees relating to other financing arrangements are deferred and amortized over the term of the loan.

### Shipping and Handling Costs

The Company accounts for shipping and handling fees in accordance with FASB ASC 705 "Cost of Sales and Services". Shipping and handling costs for the three and six months ended May 31, 2013 were \$101,561 and \$175,255, respectively (three and six months ended May 31, 2012 - \$110,540 and \$290,277, respectively). Costs related to raw materials purchased, are included in inventory or cost of goods sold, as appropriate. While amounts charged to customers for shipping product are included in revenues, the related outbound freight costs are included in expenses as incurred.

### Income Taxes and Uncertain Tax Positions

The Company accounts for income taxes under ASC 740 Accounting for Income Taxes. Under ASC 740, deferred 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. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the periods in which those temporary differences are expected to be recovered or settled. Under ASC 740, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. ASC 740-10-05, Accounting for Uncertainty in Income Taxes, prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return.

For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities.

The amount recognized is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Potential tax benefits from net operating losses and foreign tax credit carry forwards are not recognized by the Company until their realization is more likely than not. We assess the validity of our conclusions regarding uncertain tax positions on a quarterly basis to determine if facts or circumstances have arisen that might cause us to change our judgment regarding the likelihood of a tax position's sustainability under audit. The Company has determined that there were no tax exposures as at November 30, 2012 and May 31, 2013.

#### Per Share Data

Basic earnings per share ("EPS") is determined by dividing net earnings available to common stockholders (numerator) by the weighted average number of shares outstanding (denominator) during the period. In computing diluted EPS, the average number of shares of Common Stock outstanding is increased by Common Stock options and warrants outstanding with exercise prices lower than the average market price of Common Stock using the treasury stock method. Diluted earnings per share exclude all potentially dilutive shares if their effect is anti-dilutive. Potentially dilutive shares include 91,264 warrants and 383,310 Common Stock options issued and outstanding as at May 31, 2012 and 2,163,764 warrants and 483,310 Common Stock options issued and outstanding as at May 31, 2013. All outstanding warrants and options have an anti-dilutive effect on the loss per share and are therefore excluded from the determination of the diluted loss per share calculation for the three and six months ended May 31, 2012 and 2013.

#### New Accounting Pronouncements

In September 2011, the FASB issued ASU 2011 - 08, Intangibles - Goodwill and Other, which amends ASC Topic 350 and the current guidance on testing goodwill for impairment. Under the revised guidance, entities testing goodwill for impairment have the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit exceeds its carrying amount. If an entity determines it is more likely than not that the fair value of a reporting unit exceeds its carrying amount, then performing the two-step impairment test is unnecessary. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company adopted this statement effective December 1, 2012. The adoption of this guidance did not have a material effect on the Company's condensed consolidated financial statements.

In December 2011, the FASB issued ASU No. 2011-11, Disclosures about Offsetting Assets and Liabilities (Topic 210). The new disclosure requirements mandate that entities disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position as well as instruments and transactions subject to an agreement similar to a master netting arrangement. In addition, the standard requires disclosure of collateral received and posted in connection with master netting agreements or similar arrangements. The amendments are effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The disclosures required by the amendments are required to be applied retrospectively for all comparative periods presented. The Company does not believe the adoption of this standard will have a material impact on its condensed consolidated financial statements.

All other recent pronouncements issued by the FASB or other authoritative standards groups with future effective dates are either not applicable or are not expected to be significant to the consolidated financial statements of the Company.

## NOTE 3 - INVENTORIES

Inventories consisted of the following:

|                | As at<br>November<br>30,<br>2012 | As at<br>May 31,<br>2013 |
|----------------|----------------------------------|--------------------------|
| Raw materials  | \$ 330,627                       | \$ 624,444               |
| Finished goods | 739,205                          | 348,215                  |
| Equipment (i)  | 126,966                          | 126,966                  |
|                | \$ 1,196,798                     | \$ 1,099,625             |

- (i) During fiscal 2012, certain oil processing research and development related equipment previously sold in fiscal 2011 was returned.

## NOTE 4 – PROPERTY, PLANT AND EQUIPMENT

|                         | As at May 31, 2013 |                             |                   | As at<br>November<br>30,<br>2012 |
|-------------------------|--------------------|-----------------------------|-------------------|----------------------------------|
|                         | Cost               | Accumulated<br>Depreciation | Net Book<br>Value | Net Book<br>Value                |
| Sombra site:            |                    |                             |                   |                                  |
| Land                    | \$ 409,134         | \$ —                        | \$ 409,134        | \$ 409,134                       |
| Building                | 2,944,356          | 205,104                     | 2,739,252         | 2,651,631                        |
| Equipment               | 749,972            | 332,181                     | 417,791           | 469,545                          |
| Equipment - Denami 3000 | 4,164,968          | 106,228                     | 4,058,740         | 3,939,234                        |
| Mississauga site:       |                    |                             |                   |                                  |
| Computer equipment      | 34,151             | 24,572                      | 9,579             | 9,425                            |
| Leasehold improvements  | 102,201            | 50,414                      | 51,787            | 56,984                           |
| Equipment and fixtures  | 255,463            | 164,477                     | 90,986            | 108,681                          |
| Equipment - Denami 600  | 720,042            | 147,251                     | 572,791           | 587,192                          |
|                         | \$ 9,380,287       | \$ 1,030,227                | \$ 8,350,060      | \$ 8,231,826                     |

Total depreciation expense included in selling, general and administrative expenses in the condensed consolidated statements of operations related to property, plant and equipment for the three and six months ended May 31, 2013 was \$117,177 and \$233,593, respectively (three and six months ended May 31, 2012 - \$56,049 and \$99,475, respectively).



## NOTE 5 - PAYABLE TO RELATED PARTIES AND OTHERS

Payable to related parties and others is comprised of the following:

|  | As at<br>November<br>30,<br>2012 | As at<br>May 31,<br>2013 |
|--|----------------------------------|--------------------------|
| Softdiffusion SA (stockholder)               | \$ 49,333                        | \$ 50,933                |
| Nalini Khetia (non-related party)            | —                                | 68,250                   |
| Michel G. Laporte (stockholder and Director) | 172,389                          | 631,520                  |
| World Asset Management Inc. (stockholder)    | 1,396,277                        | 1,444,277                |
|  | \$ 1,617,999                     | \$ 2,194,980             |

The related party payables and others bear interest at a rate of 8% per annum, are unsecured and repayable on demand. Interest expense incurred during the three and six months ended May 31, 2013 was \$28,465 and \$60,625, respectively (three and six months ended May 31, 2012 - \$21,640 and \$31,040, respectively). Accrued interest of \$147,999 and \$207,465 was included in the above balances as at November 30, 2012 and May 31, 2013, respectively.

## NOTE 6 - SHORT-TERM LOANS

On June 20, 2012, Methes Canada entered into a term loan facility agreement with a lender that will allow Methes Canada to borrow up to \$1,446,750 (historical amount of \$1,464,900 or CDN\$1,500,000). The term loan, which was drawn in late June 2012, is repayable in 12 months and bears interest at 23% per annum. The loan is prepayable by Methes Canada after six months upon payment of a penalty equal to one-month's interest. The facility is guaranteed by the Company and collateralized by a general security agreement from Methes Canada and a first collateral mortgage on certain assets located at Sombra. The facility prohibits payment of debt in excess of \$550,000 owed by the Company to certain of its stockholders and directors during the life of the facility and contains other customary debt covenants. The facility also provides that, beginning October 1, 2012, any additional operating losses incurred by Methes Canada must be financed by stockholders or new equity funding. Interest expense incurred during the three and six months ended May 31, 2013 was \$84,903 and \$171,153, respectively (three and six months ended May 31, 2012 - \$nil in each period).

On January 26, 2013, the Company borrowed \$385,800 (historical amount of \$397,400 or CDN \$400,000) from a lender and issued to the lender a demand promissory note in the principal amount of CDN \$400,000 bearing interest of 8% per annum. Repayment of the loan and payment of the accrued interest will be due upon demand. Interest expense incurred during the three and six months ended May 31, 2013 was \$7,914 and \$10,576, respectively (three and six months ended May 31, 2012 - \$nil in each period).

Accrued interest of \$nil and \$10,576 was included in the short-term loans as at November 30, 2012 and May 31, 2013, respectively.

## NOTE 7 - STOCKHOLDERS' EQUITY

The Company is authorized to issue 75,000,000 shares of Common Stock with a par value of \$0.001 and had 6,553,169 and 6,978,169 shares of Common Stock issued and outstanding as of November 30, 2012 and May 31, 2013, respectively.

The Company is also authorized to issue 10,000,000 shares of Preferred Stock with a par value of \$0.001 and had no shares of Preferred Stock issued or outstanding as of November 30, 2012 and May 31, 2013.

In the February 2013 Private Placement, the Company issued 425,000 Units to accredited investors at a price of \$4.00 per unit under a private placement and raised net proceeds of approximately \$1.4 million, after deducting the sales commission and fees. Each unit consists of one share of Common Stock, one Class A Warrant and one Class B Warrant, identical to the securities issued under the IPO. Each Class A and Class B warrant is exercisable to purchase one share of Common Stock at \$7.50 and \$10.00, respectively, and expires on October 12, 2017.

In connection with the issuance of the Units in the February 2013 Private Placement, the Company issued warrants to purchase an aggregate of 42,500 Units, with an exercise price of \$4.20 per Unit, to the placement agents for the February 2013 Private Placement. The fair value of these warrants on the issuance date was \$101,600, which has been recorded to additional paid-in capital. This amount was estimated using the Black-Scholes option pricing model with an expected life of 5 years, a risk free interest rate of 0.89%, a dividend yield of 0%, and an expected volatility of 75%.

During the six months ended May 31, 2012, the Company issued 211,787 shares of Common Stock for cash at \$7.67 per share and 26,075 Common Stock warrants at an exercise price of \$7.67. The warrants are exercisable for a period of one year commencing from October 25, 2012, the date the Company started trading publicly on the NASDAQ.

On November 23, 2011, the Company issued together with 130,378 shares of Common Stock, 65,189 Common Stock warrants at an exercise price of \$7.67. The warrants are exercisable for a period of one year commencing from October 25, 2012, the date the Company started trading publicly on the NASDAQ. The warrant holders are generally protected from anti-dilution by adjustments for any stock dividends, stock splits, combinations or other recapitalizations. In addition, the Company was required to issue or cause to be transferred 52,151 shares of additional Common Stock as penalty shares should the Company not be listed on the NASDAQ or the NYSE MKT, and did not meet certain operating requirements, on or before July 1, 2012. As the Company was not listed on the NASDAQ or the NYSE MKT, and did not meet certain operating requirements, by July 1, 2012, Softdiffusion SA transferred 52,151 shares of Common Stock with an estimated fair value of \$7.67 per share to a new shareholder as settlement for the penalty share obligation. The estimated fair value of \$399,998 for these shares was recorded by the Company and is included in additional paid-in capital for the fiscal year ended November 30, 2012.

#### NOTE 8 - STOCK-BASED COMPENSATION

##### 2008 Option Plan:

The Company's Amended and Restated 2008 Directors, Officers and Employees Stock Option Plan, which was originally approved by stockholders at the annual general meeting of the Company held on December 5, 2007, and subsequently amended by the stockholders on July 23, 2008. This plan was established to enable the Company to attract and retain the services of highly qualified and experienced directors, officers, employees and consultants and to give such persons an interest in the success of the Company and its subsidiaries. The total number of shares currently authorized under the plan is 391,134. The options and awards will be granted at the direction of the Board of Directors. Options issued under the plan that are deemed to be incentive stock options will be priced at not less than 100 percent of the fair market value of the shares of Common Stock underlying the options at the date of the grant, subject to certain limitations for 10 percent stockholders. The fair value of each option granted during the three months ended May 31, 2012 and 2013 was estimated at the time of grant using the Black-Scholes option pricing model and are as follows:

| Three Months Ended        | May 31,<br>2012 | May 31,<br>2013 |
|---------------------------|-----------------|-----------------|
| Exercise price (\$)       | 7.67            | N/A             |
| Risk-free interest rate   | 1.92%           | N/A             |
| Expected term (Years)     | 10              | N/A             |
| Expected volatility       | 100%            | N/A             |
| Expected dividend yield   | 0%              | N/A             |
| Fair value of option (\$) | 6.86            | N/A             |
| Expected forfeiture rate  | Nil             | N/A             |

All the grants vest quarterly over a two year period and expire on the tenth anniversary of the grant date. The following table summarizes the stock option activities of the Company.

|                                     | Number of<br>options |
|-------------------------------------|----------------------|
| Outstanding as of November 30, 2011 | 338,983              |
| Granted                             | 44,327               |
| Exercised                           | —                    |
| Cancelled/forfeited                 | —                    |

|  |         |
|--|---------|
| Outstanding as of May 31, 2012, November 30, 2012 and May 31, 2013 | 383,310 |
|--|---------|

The share-based compensation for the three and six months ended May 31, 2013 was \$28,150 and \$66,632, respectively (three and six months ended May 31, 2012 - \$53,899 and \$122,567, respectively). The Company recorded this in general and administrative expenses with a corresponding credit to additional paid-in capital.

As of November 30, 2012 the Company has granted a total of 383,310 options to purchase Common Stock to employees, directors and advisory board members, all of which are currently outstanding and of which 350,716 are vested and exercisable. All of these outstanding stock options have an exercise price above the fair market price on the grant dates. As of November 30, 2012, the total fair value of the options granted to employees at the respective grant dates was \$1,458,698, of which the unrecognized portion of \$107,882 related to the unvested shares associated with these stock option grants will be recognized over a period of two years from the respective grant dates.

As of May 31, 2013 the Company has granted a total of 383,310 options to purchase Common Stock to employees, directors and advisory board members, all of which are currently outstanding and of which 377,117 are vested and exercisable. All of these outstanding stock options have an exercise price above the fair market price on the grant dates. As of May 31, 2013, the total fair value of the options granted to employees at the respective grant dates was \$1,458,698, of which the unrecognized portion of \$41,250 related to the unvested shares associated with these stock option grants will be recognized over a period of two years from the respective grant dates.

2012 Option Plan:

Under the Company's 2012 Directors, Officers and Employees Stock Option Plan the company granted a total of 100,000 options to purchase Common Stock to its four directors and chief financial officer on April 2, 2013. The total number of shares currently authorized under the plan is 400,000. The options and awards will be granted at the direction of the Board of Directors. Options issued under the plan that are deemed to be incentive stock options will be priced at not less than 100 percent of the fair market value of the shares of Common Stock underlying the options at the date of the grant, subject to certain limitations for 10 percent stockholders. The fair value of each option granted during the three months ended May 31, 2012 and 2013 was estimated at the time of grant using the Black-Scholes option pricing model and are as follows:

| Three Months Ended        | May 31,<br>2012 | May 31,<br>2013 |
|---------------------------|-----------------|-----------------|
| Exercise price (\$)       | N/A             | 3.94            |
| Risk-free interest rate   | N/A             | 0.78%           |
| Expected term (Years)     | N/A             | 5               |
| Expected volatility       | N/A             | 100%            |
| Expected dividend yield   | N/A             | 0%              |
| Fair value of option (\$) | N/A             | 2.92            |
| Expected forfeiture rate  | N/A             | Nil             |

All the grants vest yearly at the rate of 1/3 starting on the first year anniversary of the grant date and expire on the fifth anniversary of the grant date. The following table summarizes the stock option activities of the Company.

|                                     | Number of<br>options |
|-------------------------------------|----------------------|
| Outstanding as of November 30, 2012 | —                    |
| Granted                             | 100,000              |
| Exercised                           | —                    |
| Cancelled/forfeited                 | —                    |
| Outstanding as of May 31, 2013      | 100,000              |

The share-based compensation for the three and six months ended May 31, 2013 was \$nil in each period (three and six months ended May 31, 2012 - \$nil in each period).

As of May 31, 2013 the Company granted options to purchase a total of 100,000 shares of Common Stock at an exercise price of \$3.94 per share, to its four independent directors and chief financial officer, all of which are currently outstanding and of which none are vested and exercisable. All of these outstanding stock options have an exercise price equal to the fair market price on the date of grant. As of May 31, 2013, the total fair value of the options granted to the independent directors and chief financial officer at the respective grant dates was \$292,174, of which the unrecognized portion of \$292,174 related to the unvested shares associated with these stock option grants will be recognized over a period of three years.

NOTE 9 - FAIR VALUE MEASUREMENTS, CONCENTRATIONS AND RISK

a) The Company's cash and cash equivalents, which are carried at fair values, are classified as a level 1 financial instrument at November 30, 2012 and May 31, 2013.

b) The Company is exposed to the following concentrations of risk:

Major Customers

Two major customers comprised 66% and 22% of total revenue for the three months ended May 31, 2013 (three months ended May 31, 2012 - two major customers accounted for 65% and 20% of total revenue). Two major customers comprised 60% and 24% of total revenue for the six months ended May 31, 2013 (six months ended May 31, 2012 - two major customer comprised 54% and 28% of total revenue).

Major Vendor

The Company has an exclusive agreement to manufacture biodiesel processor equipment with Turn-Key Modular Systems Inc. ("Turnkey"). During the three and six months ended May 31, 2013, the Company made purchases of \$nil and \$45,893 (three and six months ended May 31, 2012 - \$2,961,750 and \$2,961,750) from Turnkey. As of November 30, 2012 and May 31, 2013, the Company had accounts payable of \$51,414 and \$36,909 owing to Turnkey, respectively.

Economic and Political Risks

The Company faces a number of risks and challenges as a result of having primary operations and marketing in Canada. Changing political climates in Canada could have a significant effect on the Company's business.

c) The Company's financial instruments are exposed to certain financial risks, including credit risk, currency risk and liquidity risk.

### Credit Risk

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's cash and cash equivalents and trade accounts receivable. The Company places its cash and cash equivalents with institutions of high creditworthiness. The carrying value of the financial assets represents the maximum credit exposure.

The Company minimizes credit risk by routinely reviewing the credit risk of the counterparty to the arrangement and has maintained an allowance for doubtful accounts of \$30,000 related to credit risk as at May 31, 2013, which is considered adequate. A balance of \$26,128 and \$72,356 was due from a major customer as at November 30, 2012 and May 31, 2013, respectively.

### Currency Risk

The Company is exposed to the financial risk related to the fluctuation of foreign exchange rates. The Company's functional currency is U.S. dollars. A significant change in the currency exchange rates between the U.S. dollar relative to the Canadian dollar could have an effect on the Company's results of operations, financial position and cash flows. The Company has not entered into any derivative financial instruments to manage exposures to currency fluctuations.

Included in selling general and administrative expenses are foreign currency gains during the three and six months ended May 31, 2013 of \$1,579 and \$75,959, respectively (three and six months ended May 31, 2012 of \$30,759 and \$113,922, respectively).

### Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company has a planning and budgeting process in place to help determine the funds required to support the Company's normal operating requirements on an ongoing basis. The Company ensures that there are sufficient funds to meet its short-term business requirements, taking into account its anticipated cash flows from operations and its holdings of cash.

As at May 31, 2013, due in large part to the funds spent to develop, build and commission the Sombra facility as well as minimal sales of biodiesel, the Company had a working capital deficiency of \$4,434,647.

As described in note 1, the Company anticipates that its Sombra facility will generate positive cash flow from operations and will operate profitably once sufficient level of commercial operation is achieved in the second half of the current fiscal year. It is management's opinion that its cash and cash equivalents, the anticipated positive cash flow from operations and cash from additional loans, including the Term Loan Facility disclosed in Note 13 - Subsequent Events, as well as private financing which is currently under negotiations, will be sufficient to meet the Company's cash requirements for at least the next 12 months.

### NOTE 10 - COMMITMENTS

The Company is a party to a lease agreement for the Mississauga facility for a five year lease term starting from January 1, 2013 to December 31, 2017. The renewed lease term provides for a two month's rent free period in 2013.

As at May 31, 2013, the Company must pay, in addition to other amounts such as the Company's pro rata share of taxes, the following amounts over the term of the lease:



|      | Annual<br>Minimum<br>Rent |
|------|---------------------------|
| 2013 | \$ 69,906                 |
| 2014 | \$ 139,812                |
| 2015 | \$ 139,812                |
| 2016 | \$ 139,812                |
| 2017 | \$ 139,812                |
| 2018 | \$ 11,651                 |

As at May 31, 2013, the Company is also a party to the following lease agreements for railcars at its Sombra facility:

|                                     | Start Date          | End Date             | Term                      |
|-------------------------------------|---------------------|----------------------|---------------------------|
| Four railcars at \$3,100 per month  | August 1, 2013      | July 31, 2018        | 60 months                 |
| Four railcars at \$3,100 per month  | April 1, 2013       | March 31, 2018       | 60 months                 |
| Four railcars at \$ 3,600 per month | July 1, 2013        | June 30, 2018        | 60 months                 |
| Four railcars at \$3,140 per month  | December 1,<br>2011 | November 30,<br>2016 | 60 months                 |
| One railcar at \$575 per month      | January 1, 2012     | December 31,<br>2016 | 60 months                 |
| One railcar at \$575 per month      | May 1, 2012         | June 30, 2015        | 36 months                 |
| Ten railcars at \$8,460 per month   | May 1, 2013         | Apr 30, 2018         | 60 months                 |
| Ten railcars at \$8,510 per month   | May 1, 2013         | April 30, 2018       | 60 months                 |
|                                     |                     |                      | Annual<br>Minimum<br>Rent |
| 2013                                |                     |                      | \$ 182,080                |
| 2014                                |                     |                      | \$ 372,720                |
| 2015                                |                     |                      | \$ 369,845                |
| 2016                                |                     |                      | \$ 365,820                |
| 2017                                |                     |                      | \$ 321,815                |
| 2018                                |                     |                      | \$ 147,250                |

#### NOTE 11 - CONTRIBUTION AGREEMENTS WITH MINISTER OF NATURAL RESOURCES OF CANADA

##### Mississauga Facility:

In 2009, the Company entered into a Non-Refundable Contribution Agreement with the Minister of Natural Resources of Canada for the Mississauga facility under the ecoENERGY for Biofuels program. Under the agreement, as amended as at May 13, 2013, the Company may receive up to \$5,217,945 (CDN\$5,410,000) in the years from 2009 to 2016 from the Canadian government in biodiesel production incentives when biodiesel is produced and sold. The contribution from the Canadian Government is non-refundable by the Company.

For the three and six months ended May 31, 2013, the Company claimed incentives of \$8,559 and \$10,170, respectively (three and six months ended May 31, 2012 - \$150,440 and \$244,456, respectively) for the biodiesel produced from its Mississauga facility. Since entering into the program to May 31, 2013, the Company has claimed total incentives of \$1,458,285 of which it has received a total of \$1,449,265.

Included in accounts receivable as at November 30, 2012 and May 31, 2013, is an amount receivable of \$46,816 and \$9,020, respectively, due from the Minister of Natural Resources of Canada.

##### Sombra Facility:

In 2010, the Company applied for an incentive under the ecoENERGY for Biofuels program for its Sombra facility and was approved by the Canadian government. The final Contribution Agreement with the Minister of Natural Resources of Canada for the Sombra facility under the ecoENERGY for Biofuels program was signed by the Company and the Canadian Government on December 6, 2011. Under the agreement, as amended as at April 16, 2013, the Company may receive up to \$14,260,325 (CDN\$14,785,200) from the years 2012 to 2017 from the Canadian government in biodiesel production incentives when biodiesel is produced and sold. The contribution from

the Canadian Government is non-refundable by the Company.

For the three and six months ended May 31, 2013, the Company claimed incentives of \$161,565 and \$168,833 (three and six months ended May 31, 2012 - \$nil in each period) for the biodiesel produced from its Sombra facility. Since entering into the program in 2010 to May 31, 2013, the Company has claimed total incentives of \$168,833 of which it has received a total of \$nil.

Included in accounts receivable as at November 30, 2012 and May 31, 2013, is an amount receivable of \$nil and \$168,833, respectively, due from the Minister of Natural Resources of Canada.

## NOTE 12 - SEGMENT INFORMATION

The Company reports a single operating segment, being a producer and seller of biodiesel fuel and biodiesel processing equipment.

Geographic segments:

The Company's assets and operating facilities, other than cash balances of \$336,065 at November 30, 2012 and \$15,810 at May 31, 2013, are all located in Canada. The Company services the majority of its customers in the United States. The Company derives its revenue geographically as follows:

|               | Three<br>Months<br>Ended<br>May 31,<br>2012 | Three<br>Months<br>Ended<br>May 31,<br>2013 | Six Months<br>Ended<br>May 31,<br>2012 | Six Months<br>Ended<br>May 31,<br>2013 |
|---------------|---|---|--|--|
| Revenue       |   |   |  |  |
| United States | \$1,361,382                                 | \$2,071,344                                 | \$3,989,713                            | \$2,171,133                            |
| Canada        | 720,841                                     | 257,010                                     | 1,074,687                              | 367,332                                |
|               | \$2,082,223                                 | \$2,328,354                                 | \$5,064,400                            | \$2,538,465                            |

## NOTE 13 - SUBSEQUENT EVENTS

The Company has performed an evaluation of subsequent events through July 12, 2013, and has determined there have been no material subsequent events requiring disclosure.

On July 12, 2013, Methes Canada entered into a Term Loan Facility Agreement with 1730636 Ontario Limited (the "Agreement") pursuant to which Methes Canada may borrow up to \$1,536,000 (CDN\$1,600,000) for a term of 12 months at an interest rate of 12% per annum. Under the terms of the Agreement, interest is payable monthly and outstanding principal is due at maturity. Outstanding principal would be prepayable after six months upon 30 days' notice and payment of a penalty equal to one-month's interest. Upon closing, the facility will be collateralized by a security agreement from Methes Canada on certain of its assets and a first collateral mortgage on its real property located at Sombra, Ontario. The facility prohibits payment of debt owed by the Company to certain of its stockholders and a director during the life of the facility and contains other customary debt covenants.

The proceeds from this loan will be used to repay the short-term loan of \$1,446,750 (historical amount of CDN\$1,500,000), as disclosed in Note 6.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and related notes included elsewhere in this report. Some of the statements in this discussion and elsewhere in this report constitute forward-looking statements within the meaning of Section 21E of the Securities and Exchange Act of 1934. See "Cautionary Statement Regarding Forward-Looking Information" following the Table of Contents of this report. Because this discussion involves risk and uncertainties, our actual results may differ materially from those anticipated in these forward-looking statements.

### Overview

We are a renewable energy company that offers an array of products and services to a network of biodiesel fuel producers. We also market and sell in the U.S. and Canada biodiesel fuel produced at our small-scale production and demonstration facility in Mississauga, Ontario, Canada, and have recently commissioned and are scaling-up biodiesel production at our new facility in Sombra, Ontario, Canada.

Among other services, we sell feedstock to our network of biodiesel producers, sell their output in the U.S. and Canada, provide them with proprietary software used to operate and control their processors, remotely monitor the quality and characteristics of their output, upgrade and repair their processors, and advise them on adjusting their processes to use varying feedstock and improve their output. Through the accumulation of production data from our network, we are equipped to provide consulting services to network members and other producers for operating their facilities, maintaining optimum production and solving production problems. For our network services and the license of our operating and communications software, we receive a royalty from network members based on the gallons of biodiesel produced.

Our revenue sources include the sale of biodiesel produced at our own facility, the sale of biodiesel that we purchase from network members and other third-party producers, the sale of biodiesel equipment, the sale of feedstock to network members and other third-party biodiesel producers, Canadian government incentive payments, royalties from our network members, and revenue from other services we provide related to the production of biodiesel.

As at May 31, 2013, due in large part to the funds spent to develop, build and commission our Sombra facility as well as reduced sales of biodiesel which we believed were primarily due to invalid RINs (defined below) generated and sold by some U.S. producers in late 2011 and early 2012, we had a working capital deficiency of \$4,434,647. During the six months ended May 31, 2013, we incurred a loss of \$2,883,143 and had negative cash flow from operations of \$2,136,667.

In October 2012, our Sombra facility was approved by the U.S. Environmental Protection Agency ("EPA") as a Foreign Renewable Fuel Producer and as a result the biodiesel produced at this facility became eligible for export to the United States. Obtaining this approval from the EPA enables us to sell our biodiesel into the U.S., and provides our U.S. importers the ability to generate Renewable Identification Numbers ("RINs"). RINs are used in the U.S. by obligated parties to comply with certain obligations under the Renewable Fuel Standard 2 ("RFS2").

On October 12, 2012, our registration statement on Form S-1 (File No. 333-182302) for our initial public offering ("IPO") was declared effective by the U.S. Securities and Exchange Commission ("SEC"). On October 30, 2012, we consummated our IPO pursuant to which we sold 560,000 units (each a "Unit") at a price \$5.00 per Unit and raised net proceeds of approximately \$1.8 million, after deducting the underwriting fees and offering expenses. Each Unit consists of (i) one share of Common Stock, (ii) one Class A warrant, to purchase one share of Common Stock at an exercise price of \$7.50, and (iii) one Class B warrant, to purchase one share of Common Stock at an exercise price of

\$10.00.

On February 19, 2013, we completed a private placement under which we sold 425,000 Units at a price of \$4.00 per Unit and raised net proceeds of approximately \$1.4 million, after deducting the sales commission and fees. Each Unit consists of (i) one share of common stock, \$.001 par value (“Common Stock”), (ii) one Class A Warrant, to purchase one share of Common Stock at an exercise price of \$7.50, and (iii) one Class B Warrant, to purchase one share of Common Stock at an exercise price of \$10.00 (the “February 2013 Private Placement”).

The consolidated financial statements include our accounts and the accounts of our wholly-owned subsidiaries Methes Energies Canada Inc. (“Methes Canada”) and Methes Energies USA Ltd. (“Methes USA”). All significant inter-company transactions and balances have been eliminated.

## Factors Influencing Our Results of Operations

The principal factors affecting our results of operations are as follows:

### Biodiesel and feedstock price fluctuations

Biodiesel is a low carbon, renewable alternative to petroleum-based diesel fuel and is primarily sold to the end user after it has been blended with petroleum-based diesel fuel. Biodiesel prices have historically been correlated to petroleum-based diesel fuel prices. Accordingly, biodiesel prices have generally been affected by the same factors that affect petroleum prices, such as worldwide economic conditions, wars and other political events, OPEC production quotas, changes in refining capacity and natural disasters. Recently enacted government requirements and incentive programs, such as RFS2 and the blenders' tax credit, which expires on December 31, 2013, have reduced this correlation, although it remains a significant factor in the market price of our product.

Our operating results also generally reflect the relationship between the price of biodiesel and the price of the feedstock used to produce biodiesel. Spot market prices for virgin vegetable oil or used vegetable oil or rendered animal fat may increase, which would adversely affect our gross margins. The price of vegetable oil, as with most other products made from crops, is affected by weather, disease, changes in government incentives, demand and other factors. A significant reduction in the supply of vegetable oil because of weather or disease, or increases in the demand for vegetable oil, could result in higher feedstock prices. The price of vegetable oil and other feedstock has fluctuated significantly in the past and may fluctuate significantly in the future.

### Government programs related to biodiesel production and use

Biodiesel has been more expensive to produce than petroleum-based diesel fuel and as a result the industry depends on Canadian and U.S. federal and, to a lesser extent, provincial and state usage requirements and tax incentives.

On July 1, 2010, RFS2 was implemented, stipulating volume requirements for the amount of biomass-based diesel that must be utilized in the United States each year. Under RFS2, obligated parties, including petroleum refiners and fuel importers, must show compliance with these standards. The RFS2 program required the domestic use of 800 million gallons of biodiesel in 2011 and one billion gallons in 2012. The EPA recently mandated a requirement for domestic use of biodiesel by obligated parties of 1.28 billion gallons in 2013.

### Renewable Identification Numbers ("RINs")

RINs are used to track compliance with RFS2 and are generated when a gallon of biodiesel is produced or imported into the U.S. In late 2011 and early 2012 the EPA announced that some U.S. producers had generated and sold invalid RINs. The loss of integrity and confidence in the RINs market affected the demand as well as the price of biodiesel. This problem has now been corrected by the EPA with the introduction of Quality Assurance Programs ("QAPs").

In February 2013, the EPA introduced two new QAPs that would allow buyers of RINs to verify their validity. The QAPs provide a clear path and system for independent third parties, approved by the EPA, to audit and monitor, on an ongoing basis, the production of biodiesel and verify that RINs have been correctly generated. The QAPs, once fully in place, will be retroactive to January 1, 2013.

#### Seasonal fluctuations

Our operating results are influenced by seasonal fluctuations in the price of biodiesel. Our sales tend to decrease during the winter season due to perceptions that biodiesel will not perform adequately in colder weather. Colder seasonal temperatures can cause the higher cloud point biodiesel we make from inedible animal fats to become cloudy and eventually gel at a higher temperature than petroleum-based diesel or lower cloud point biodiesel made from soybean, canola or inedible corn oil. Reduced demand in the winter for our higher cloud point biodiesel may result in excess supply of such higher cloud point biodiesel or lower prices for such higher cloud point biodiesel. In addition, our production facilities are located in Canada and our costs of shipping biodiesel to warmer climates generally increase in cold weather months.

#### Dependence on significant customers

A large part of our revenue is generated from a few large customers. The sales to these customers are made at spot market prices, and we have no binding purchase agreements for our biodiesel, which could affect the consistency of our revenues. Potential customers for biodiesel regularly bid for biodiesel in the spot market at prices that are quoted on a daily basis. As a matter of convenience, we prefer to deal with customers with whom we have had a past relationship, although the specific customers to whom we sell have varied over time. The loss of one or more customers who have been among our largest customers historically would not have a material adverse effect on our business because we believe that a customer or customers could be replaced by one or more new customers regularly bidding for biodiesel, and we believe this will continue to be the case. For example, in the six months ended May 31, 2013, one new major customer accounted for 24% of our total revenue and our largest customer improved to 60% of total revenue in the six-month period ended May 31, 2013 from 54% of total revenue in same period in fiscal 2012.

#### Lengthy sales cycle

The sale of one of our Denami processors in a particular financial period has a significant effect on our quarter-to-quarter and year-to-year results. The purchase of our Denami processors involves a significant commitment of capital by customers, with the attendant delays frequently associated with large capital expenditures. For these and other reasons, the sales cycle associated with our Denami processors is typically lengthy, varying from 6 to 18 months. The lengthy sales cycles of our equipment sales, as well as the size and timing of orders, make it difficult to forecast our future results of operations.



## Results of Operations

Three and six months ended May 31, 2012 and 2013

Set forth below is a summary of certain financial information for the periods indicated:

|  | Three<br>Months<br>Ended<br>May 31,<br>2012 | Three<br>Months<br>Ended<br>May 31,<br>2013 | Six Months<br>Ended<br>May 31,<br>2012 | Six Months<br>Ended<br>May 31,<br>2013 |
|--|---|---|--|--|
| Revenue                                      |   |   |  |  |
| Biodiesel sales                              |   |   |  |  |
| Resales                                      | \$705,218                                   | \$415,782                                   | \$2,528,798                            | \$463,9460                             |
| Internal production                          | 1,058,879                                   | 1,664,522                                   | 1,786,190                              | 1,747,244                              |
| Feedstock sales                              | 49,213                                      | 40,802                                      | 283,961                                | 84,988                                 |
| Glycerin sales                               | 21,098                                      | 22,635                                      | 49,767                                 | 36,441                                 |
| Government incentives                        | 150,440                                     | 170,124                                     | 244,456                                | 179,004                                |
| Equipment sales                              | 7,592                                       | 2,657                                       | 16,500                                 | 2,657                                  |
| Royalties                                    | 9,597                                       | 2,793                                       | 44,279                                 | 6,775                                  |
| Others                                       | 80,186                                      | 9,039                                       | 110,448                                | 17,860                                 |
|  | 2,082,223                                   | 2,328,354                                   | 5,064,400                              | 2,538,465                              |
| Cost of goods sold                           | 1,681,147                                   | 2,221,184                                   | 4,438,052                              | 2,410,713                              |
| Gross profit                                 | 401,076                                     | 107,170                                     | 626,348                                | 127,752                                |
| Operating expenses                           |   |   |  |  |
| Selling, general and administrative expenses |   |   |  |  |
|  | 957,510                                     | 1,476,838                                   | 1,807,435                              | 2,767,926                              |
| Loss before interest and taxes               | (556,434 )                                  | (1,369,668 )                                | (1,181,087 )                           | (2,640,174 )                           |
| Other expenses                               |   |   |  |  |
| Interest expense                             | (22,261 )                                   | (122,143 )                                  | (31,448 )                              | (242,969 )                             |
| Loss before income taxes                     | (578,695 )                                  | (1,491,811 )                                | (1,212,535 )                           | (2,883,143 )                           |
| Income taxes                                 |   |   |  |  |
|  | —   | —   | —                                      | —                                      |
| Net loss for the period                      | \$(578,695 )                                | \$(1,491,811 )                              | \$(1,212,535 )                         | \$(2,883,143 )                         |

Three and six months ended May 31, 2012 compared to three and six months ended May 31, 2013

Revenue. Our total revenues for the three months ended May 31, 2012 and 2013 were \$2.08 million and \$2.33 million, respectively, representing an increase of \$246,131, or 12%. Our total revenues for the six months ended May 31, 2012 and 2013 were \$5.06 million and \$2.54 million, respectively, representing a decrease of \$2.52 million, or 50%. The reasons for these changes are outlined below.

Biodiesel. Biodiesel sales for the three months ended May 31, 2012, excluding government incentives, were \$1.76 million and increased by \$320,000, or 18%, to \$2.08 million in the three months ended May 31, 2013. For the three months ended May 31, 2012 and 2013, our resales of biodiesel purchased from third party producers were \$705,000 and \$416,000, respectively, a decrease of approximately \$289,000, or 41%. Revenue from our internal production, excluding government incentives, for the three months ended May 31, 2012 and 2013 was \$1.06 million and \$1.66 million, respectively, an increase of \$600,000, or 57%. For the three months ended May 31, 2012 and 2013, our average sales price per gallon for 100 percent biodiesel ("B100") was \$4.44 and \$4.11, respectively, a decrease of \$0.33 per gallon, or 7%. The decrease in our average sales price per gallon in the three months ended May 31, 2013 was due to some fixed price contracts that we entered into in early 2013. Gallons sold for the three months ended May 31, 2012 and 2013 were 397,000 and 506,000 gallons, respectively, an increase of 109,000 gallons, or 22%.

Biodiesel sales for the six months ended May 31, 2012, excluding government incentives, were \$4.31 million and decreased by \$2.1 million, or 49%, to \$2.21 million in the six months ended May 31, 2013. For the six months ended May 31, 2012 and 2013, our resales of biodiesel purchased from third party producers were \$2.53 million and \$463,000, respectively, a decrease of approximately \$2.07 million, or 82%. Revenue from our internal production, excluding government incentives, for the six months ended May 31, 2012 and 2013 was \$1.79 million and \$1.75 million, respectively, a decrease of \$40,000, or 2%. For the six months ended May 31, 2012 and 2013, our average sales price per gallon for 100 percent biodiesel ("B100") was \$4.49 and \$4.13, respectively, a decrease of \$0.36 per gallon, or 8%. The decrease in our average sales price per gallon in the six months ended May 31, 2013 was due to some fixed price contracts that we entered into in early 2013. Gallons sold for the six months ended May 31, 2012 and 2013 were 961,377 and 535,447 gallons, respectively, a decrease of 425,930 gallons, or 44%.

The decrease in revenue from the sales of our biodiesel and the resales of biodiesel purchased from others was primarily due to a much lower demand for biodiesel which we believe was caused by the remaining uncertainty about the integrity of RINs market in the United States caused by invalid RINs sold by some U.S. producers in late 2011 and early 2012. As a small and medium size producer, we and our existing customers have been directly affected by this situation. Another factor contributing to the lower sales of our biodiesel during the current quarter was the production and start-up issues that we faced at our Sombra facility which resulted in delays in shipments to customers and lower production. These issues have now been resolved.

In early February 2013, the EPA introduced QAPs that would allow buyers of RINs to verify their validity. The QAPs provide a clear path and system for independent third parties, approved by the EPA, to audit and monitor, on an ongoing basis, the production of biodiesel and verify that RINs have been correctly generated. We believe that the QAP's coupled with the EPA's mandate that 1.28 billion gallons of biodiesel be produced for domestic use in 2013 will greatly reduce the uncertainty about the integrity of RINs and increase the demand for biodiesel from us in the remaining periods of this year. At this time, we are evaluating two third party providers of QAPs which have been approved by the EPA and expect to be selecting one during this quarter.

Feedstock. For the three months ended May 31, 2012 and 2013, feedstock sales were \$49,000 and \$41,000, respectively, a decrease of \$8,000, an immaterial amount. For the six months ended May 31, 2012 and 2013, feedstock sales were \$284,000 and \$85,000, respectively, a decrease of \$199,000, or 70%. Feedstock sales were down due to lower demand for biodiesel that affected other small biodiesel producers and also due to their direct purchase

from other suppliers.

Glycerin. For the three months ended May 31, 2012 and 2013, Glycerin sales were \$21,000 and \$23,000, respectively, an increase of \$2,000, an immaterial amount. For the six months ended May 31, 2012 and 2013, Glycerin sales were \$50,000 and \$36,000, respectively, a decrease of \$14,000 or 28%. For the three months ended May 31, 2012 and 2013, the increase was a result of new production of glycerin at our Sombra facility, which is a byproduct of our biodiesel production. For the six months ended May 31, 2012 and 2013, Glycerin sales decreased because of lower biodiesel production.

Government incentives. For the three months ended May 31, 2012 and 2013, we received \$150,000 and \$170,000, respectively, of government incentives. This increase of \$20,000 or 13%, was due to the increase in production of biodiesel at our Sombra facility. For the six months ended May 31, 2012 and 2013, we received \$244,000 and \$179,000, respectively, of government incentives. This decrease of \$65,000, or 27%, was due to no production at our Mississauga facility and a slower than anticipated ramp-up in production at our Sombra facility.

Equipment sales. For the three months ended May 31, 2012 and 2013, we generated \$7,600 and \$2,700, respectively, from equipment sales. For the six months ended May 31, 2012 and 2013, we generated \$17,000 and \$2,700, respectively, from equipment sales. Equipment sales during the three and six months consisted of small lab and shop supplies.

**Royalties.** We received royalties of \$9,600 during the three months ended May 31, 2012, from two network members that purchased our Denami 600 processors late in fiscal 2010. Royalties for the three months ended May 31, 2013 were \$2,800, a decrease of \$6,800. We received royalties of \$44,000 during the six months ended May 31, 2012 from two network members that purchased our Denami 600 processors late in fiscal 2010. Royalties for the six months ended May 31, 2013 were \$6,700, a decrease of \$37,300. Our customers own the Denami 600 processors, but license the software and monitoring system from us in exchange for an ongoing royalty payment of \$0.11 per gallon of biodiesel produced by their Denami 600 processors. The lower demands for biodiesel during the six months ended May 31, 2013 lowered the amounts of royalties received.

**Other.** Other revenue includes revenue from consulting services, delivery charges, laboratory and shop supplies, storage and rental income. Other revenue for the three months ended May 31, 2012 and 2013, was \$ 80,000 and \$9,000, respectively, a decrease of \$71,000, or 89%, primarily due to decrease in sales of these services. For the six months ended May 31, 2012 and 2013, other revenue was \$110,000 and \$18,000, respectively, a decrease of \$92,000 or 84%, mainly due to a one time revenue item of a fire insurance claim and a one time large storage container sale that occurred in 2012.

**Cost of goods sold.** Our cost of goods sold for the three months ended May 31, 2012 and 2013 were \$1.68 million and \$2.22 million, respectively, an increase of \$540,000, or 32%. This increase was primarily due to increases in biodiesel sales and freight costs during the three months ended May 31, 2013. Our cost of goods sold for the six months ended May 31, 2012 and May 31, 2013 were \$4.44 million and \$2.41 million, respectively, a decrease of \$2.03 million, or 46%. The decrease was mainly due to lower biodiesel sales as a result of lower production at both of our facilities during the six months ended May 31, 2013.

Biodiesel cost of goods sold increased 24% from the three months ended May 31, 2012 compared to the same period in fiscal 2013, or from \$1.60 million for the three months ended May 31, 2012 to \$1.98 million for the three months ended May 31, 2013. If the average feedstock price and the price paid for biodiesel purchased from other biodiesel producers in Canada remained constant from the three months ended May 31, 2012 to the end of the same period in 2013, the increase in gallons of biodiesel sold would have resulted in a 28%, or \$457,000, increase in the related biodiesel cost of goods sold. The decrease in average feedstock prices for the three months ended May 31, 2012 compared the same three month period in 2013 resulted in a decrease in biodiesel cost of goods sold of \$72,000 of which \$2,000 was attributable to the lower price paid for biodiesel purchased from others.

Biodiesel cost of goods sold increased 50% from the six months ended May 31, 2012 compared to the same period in fiscal 2013, or from \$4.13 million for the six months ended May 31, 2012 to \$2.05 million for the six months ended May 31, 2013. If the average feedstock price and the price paid for biodiesel purchased from other biodiesel producers in Canada remained constant from the six months ended May 31, 2012 to the end of the same period in 2013, the decrease in gallons of biodiesel sold would have resulted in a 44%, or \$1.84 million, decrease in the related biodiesel cost of goods sold. The decrease in average feedstock prices for the six months ended May 31, 2012 compared to the same period in 2013 resulted in a decrease in biodiesel cost of goods sold of \$187,000 of which \$53,000 was attributable to the lower price paid for biodiesel purchased from others.

All other costs of goods sold, excluding biodiesel cost of goods sold, for the three months ended May 31, 2012 and 2013, were \$84,000 and \$241,000, respectively. The increase was mainly due to including freight costs in other cost of goods sold. For the six months ended May 31, 2012 and 2013, all other costs of goods sold, were \$309,000 and \$363,000, respectively.

**Selling, general and administrative expenses.** Our selling, general and administrative expenses for the three months ended May 31, 2012 and 2013 were \$ 958,000 and \$1.48 million, respectively, an increase of \$522,000, or 54%. The increase in the more recent period was mainly related to an increase in salaries and wages of \$270,000, an increase in

utilities of \$61,000 and an increase in professional fees of \$89,000. For the six months ended May 31, 2012 and 2013, selling, general and administrative expenses were \$1.81 million and \$2.77 million, respectively, an increase of \$960,000, or 53%. The increase in six months ended May 31, 2013 was mainly related to an increase in salaries and wages of \$483,000, an increase in utilities of \$336,000 and an increase in depreciation expense of \$135,000. The increases in salaries and wages, and utilities were necessary to support the higher level of operations at our Sombra facility.

Other expenses. For the three months ended May 31, 2012 and 2013, we incurred interest expenses of \$22,000 and \$122,000, respectively. For the six months ended May 31, 2012 and 2013, we incurred interest expenses of \$32,000 and \$243,000, respectively. The increase in interest expense in 2013 was due to the interest expense on the CDN\$1.5 million term loan described below entered into in June 2012 (the "June 2012 Term Loan Facility").

Income taxes. No income tax expense or benefit was recorded during the three and six months ended May 31, 2012 and 2013 due to ongoing taxable losses. As of May 31, 2013, we were not subject to any uncertain tax exposures.

Net loss. Our net loss for the three months ended May 31, 2012 was \$579,000 and increased by \$911,000 to \$1.49 million for the three months ended May 31, 2013 due primarily to the \$540,000 increase in cost of goods sold and resultant \$294,000 decrease in gross profit, and \$522,000 increase in selling, general and administrative expenses to support our higher level of operations, which included development of, and the higher level of operations at, our Sombra facility and higher financing costs.

## Liquidity and Capital Resources

Sources of liquidity. Since inception, a significant portion of our operations has been financed through the sale of our capital stock. At November 30, 2012 and May 31, 2013, we had cash and cash equivalents of \$402,724 and \$188,486, respectively.

During the six months ended May 31, 2013, we raised net cash proceeds of approximately \$1.4 million from the February 2013 Private Placement. Additionally, on January 26, 2013, we borrowed a total of \$397,400 (CDN\$400,000) from a third party. The loan is unsecured, payable on demand and carries interest at 8% per annum.

On June 20, 2012, Methes Canada entered into the June 2012 Term Loan Facility with a lender that allows Methes Canada to borrow up to CDN\$1.5 million. The term loan, which was drawn down in late June 2012, is repayable in 12 months and bears interest at 23% per annum. The loan is repayable by Methes Canada after six months upon payment of a penalty equal to one-month's interest. The facility is guaranteed by us and collateralized by a general security agreement from Methes Canada and a first collateral mortgage on certain assets located at our Sombra facility. The facility prohibits payment of debt in excess of \$550,000 owed by us to certain of our stockholders and directors during the life of the facility and contains other customary debt covenants. The facility also provides that, beginning October 1, 2012, any additional operating losses incurred by Methes Canada must be financed by stockholders or new equity funding.

On July 12, 2013, Methes Canada entered into a Term Loan Facility Agreement with 1730636 Ontario Limited (the "Agreement") pursuant to which Methes Canada may borrow up to \$1,536,000 (CDN\$1,600,000) for a term of 12 months at an interest rate of 12% per annum. Under the terms of the Agreement, interest is payable monthly and outstanding principal is due at maturity. Outstanding principal would be prepayable after six months upon 30 days' notice and payment of a penalty equal to one-month's interest. Upon closing, the facility will be collateralized by a security agreement from Methes Canada on certain of its assets and a first collateral mortgage on its real property located at Sombra, Ontario. The facility prohibits payment of debt owed by us to certain of our stockholders and a director during the life of the facility and contains other customary debt covenants.

The proceeds from this loan will be used to repay the June 2012 Term Loan Facility.

Cash flow. The following table presents information regarding our cash flows and cash and cash equivalents for the six months ended May 31, 2012 and 2013:

|   | (Amounts rounded to<br>nearest thousands) |            |
|---|---|------------|
|   | Six Months Ended<br>May 31,               |            |
|   | 2012                                      | 2013       |
| Net cash flows used in operating activities | \$ (40)                                   | \$ (2,137) |
| Net cash flows used in investing activities | (3,813)                                   | (352)      |
| Net cash flows from financing activities    | 2,670                                     | 2,275      |
| Net change in cash and cash equivalents     | (1,183)                                   | (214)      |
| Cash and cash equivalents, end of period    | \$ 510                                    | \$ 188     |

Operating activities. The net cash used in operating activities for the six months ended May 31, 2012 of \$40,000 reflects \$1.21 million in net losses from operations, which includes total non-cash charges for depreciation, amortization and stock compensation expense of \$230,000. It also included a net working capital decrease of \$942,000, which included a decrease in accounts receivable of \$754,000, a decrease in inventories of \$535,000 and a

decrease in prepaid expenses and deposits of \$23,000, which was partially offset by a decrease in accounts payable and accrued liabilities of \$370,000. This resulted in net cash used in operations of \$40,000.

Net cash used in operating activities was \$2.14 million for the six months ended May 31, 2013. For the six months ended May 31, 2013, the net loss was \$2.88 million, which includes total non-cash items for depreciation, amortization, stock compensation expense, unrealized foreign exchange gain, deferred financing fees and accrued interest expense of \$338,000. The net cash used in operating activities included a net working capital decrease of \$408,000. Working capital decreases were a result of an increase in accounts payable and accrued liabilities of \$440,000, a decrease in inventories of \$97,000 offset by an increase in accounts receivable of \$113,000 and an increase in prepaid expenses and deposits of \$16,000. The net result was cash used in operations of \$2.14 million. Our current operating cash requirement is approximately \$329,000 per month. We expect to generate positive cash flow from operations in future periods as a result of our Sombra facility having commenced production in February 2013.

Days' sales outstanding decreased from 17 days for the three months ended May 31, 2012 to 16 days for the three months ended May 31, 2013 as a result of improvement in timing of payment by our customers. Days' sales outstanding remained constant from 27 days for the six months ended May 31, 2012 to 27 days for the six months ended May 31, 2013

Inventory turnover was two times for the three months ended May 31, 2012 and 3 times for the three months ended May 31, 2013 as a result of increase in biodiesel sales and relative decline in inventory levels during the three months ended May 31, 2013. Inventory turnover was five times for the six months ended May 31, 2012 and two times for the six months ended May 31, 2013 as a result of decline in biodiesel sales and relative increase in inventory levels during the six months ended May 31, 2013.

Investing activities. Net cash used in investing activities for the six months ended May 31, 2012 and 2013 was \$3.81 million and \$352,000, respectively, consisting of payments for additions to property, plant and equipment, mainly representing costs related to our Sombra facility.

Financing activities. Net cash provided from financing activities for the six months ended May 31, 2012 was \$2.67 million, mainly representing financing from private issuances of Common Stock of \$1.77 million and financing from related parties of \$1.03 million. Net cash provided from financing activities for the six months ended May 31, 2013 was \$2.27 million, which mainly included cash proceeds received from private issuances of Common Stock of \$1.37 million, financing from related parties of \$519,000 and short-term loan of \$386,000.

As of May 31, 2013, due in large part to the funds spent to develop, build and start-up our Sombra facility as well as lower sales of biodiesel from our Mississauga facility, we had a working capital deficiency of \$4,434,647.

As described above, on February 19, 2013, we completed the February 2013 Private Placement which raised net proceeds of approximately \$1.4 million, after deducting the sales commission and fees. We have used the net proceeds from this private placement for working capital.

We anticipate that our Sombra facility will generate positive cash flow from operations and will operate profitably once sufficient level of commercial operation is achieved in the second half of the current fiscal year. It is management's opinion that our cash and cash equivalents, the anticipated positive cash flow from operations and cash from additional loans as well as private financing which is currently under negotiations, will be sufficient to meet our cash requirements for at least the next 12 months.

Capital Expenditures. We have expended \$8.36 million to purchase our Sombra facility, retrofit that facility and equip it so it can begin full scale production of biodiesel. These funds were expended as follows: \$2.03 million for the original purchase price of the facility; \$ 1.57 million for the costs of retrofitting and \$4.76 million for Denami 3000 processors, storage tanks and other production equipment. The funds used to purchase and complete the Sombra facility were provided by the cash proceeds from private sales of Common Stock, monies borrowed from a stockholder and the June 2012 Term Loan Facility.

Future commitments. In the second quarter of 2013, we entered into a lease agreement to lease 10 additional rail cars which are due to be delivered by June 2013. The monthly commitment is for \$8,510 or \$102,120 annually. We otherwise have no material commitments for future capital expenditures.



#### Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.

#### Recent Accounting Pronouncements

For a discussion of new accounting pronouncements affecting us, refer to “Note 2 - Summary of Significant Accounting Policies” to our condensed consolidated financial statements.

#### ITEM QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

3.

As a smaller reporting company we are not required to provide the information required by this Item.

#### ITEM 4. CONTROLS AND PROCEDURES

##### (a) Evaluation of Disclosure Controls and Procedures

Our management, with the participation of both of our chief executive officer and chief financial officer, carried out an evaluation of the effectiveness of our “disclosure controls and procedures” (as defined in the Securities Exchange Act of 1934 (the “Exchange Act”) Rules 13a-15(e) and 15-d-15(e)) as of the end of the period covered by this report (the “Evaluation Date”). Based upon that evaluation, our chief executive officer and chief financial officer each concluded that as of the Evaluation Date, our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms and (ii) is accumulated and communicated to our management, including our chief executive officer and our chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

##### (b) Changes in Internal Control over Financial Reporting

There were no changes in our internal controls over financial reporting that occurred during the quarter covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Unregistered Sales

On April 2, 2013, we granted 20,000 options to purchase Common Stock at an exercise price of \$3.94 per share, the fair market value on the grant date, to each of our four independent directors and chief financial officer pursuant to the 2012 Directors, Officers and Employees Stock Option Plan. The grants were exempt from registration under the Securities Act of 1933, as amended (the "Act"), pursuant to Sections 4(a)(2) and 4(a)(5) of the Act.

Use of Proceeds

On October 12, 2012, our registration statement on Form S-1 (File No. 333-182302) for our IPO was declared effective by the SEC. The managing underwriter for the IPO was Paulson Investment Company, Inc.

On October 30, 2012, we consummated our IPO pursuant to which we sold 560,000 Units at a price \$5.00 per Unit, and raised net proceeds of approximately \$1.8 million after deducting the underwriting discount of \$252,000, the representative's and non-accountable expense allowance of \$84,000 and other estimated offering expenses of \$180,000. Each Unit consists of (i) one share of Common Stock, (ii) one Class A Warrant and (iii) one Class B Warrant. No payments were made by us to directors, officers or persons owning ten percent or more of our Common Stock or to their associates, or to our affiliates.

We have used approximately \$818,000 of the net proceeds received from the IPO for the purchase and construction of production and storage equipment, and retrofitting the building at our Sombra facility, \$251,000 for repayment of loans and the balance of approximately \$731,000 for working capital. We expect to withdraw funds from working capital over the coming months to pay for production and storage equipment and upgrade of rail tracks at our Sombra facility and to pay for additional marketing and sale expenses as described in our final prospectus dated October 12, 2012.

ITEM 6. EXHIBITS

Exhibit

| Number      | Description  |
|-------------|--|
| <u>4.1</u>  | Promissory Note, dated July 11, 2013, in the principal amount of \$1,536,000 (CDN\$1,600,000), bearing interest at the rate of 12.0% per annum issued to 1730636 Ontario Limited (the "July 2013 Note")* |
| <u>10.1</u> | Form of Non-Statutory Stock Option Agreement under the 2012 Directors, Officers and Employees Stock Option Plan*   |
| <u>10.2</u> | Form of Incentive Stock Option Agreement under the 2012 Directors, Officers and Employees Stock Option Plan*   |
| <u>10.3</u> | Term Loan Facility Agreement between Methes Energies Canada, Inc. and 1730636 Ontario Limited, dated June 24, 2013*  |
| <u>10.4</u> | Security Agreement, dated July 11, 2013, between Methes Energies Canada, Inc. and 1730636 Ontario Limited securing the July 2013 Note*   |
| <u>10.5</u> | Collateral Mortgage on the real property located at Sombra, Ontario securing the July 2013 Note*   |
| <u>31.1</u> | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*  |

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|             |   |
|-------------|---|
| <u>31.2</u> | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002* |
| <u>32.1</u> | Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002* |
| <u>32.2</u> | Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002* |
| 101.INS     | XBRL Instance Document**  |
| 101.SCH     | XBRL Taxonomy Extension Schema Document**   |
| 101.CAL     | XBRL Taxonomy Extension Calculation Linkbase Document**   |
| 101.LAB     | XBRL Taxonomy Extension Label Linkbase Document**   |
| 101.PRE     | XBRL Taxonomy Extension Presentation Linkbase Document**  |
| 101.DEF     | XBRL Taxonomy Extension Definition Linkbase Document**  |

\* Filed herewith.

\*\* Furnished with this report. In accordance with Rule 406T of Regulation S-T, the information in these exhibits shall not be deemed to be “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Methes Energies International Ltd.

Dated: July 12, 2013

/s/ Michel G. Laporte  
Michel G. Laporte, Chief Executive  
Officer  
(Principal Executive Officer)

Dated: July 12, 2013

/s/ Edward A. Stoltenberg  
Edward A. Stoltenberg, Chief  
Financial Officer  
(Principal Financial Officer)