



Covalon Technologies Ltd.
Advancing Medical Biosystems

MANAGEMENT'S DISCUSSION & ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

For the three month period ended December 31, 2006

The following management's discussion and analysis ("MD&A"), dated February 26, 2007, provides an update to the MD&A for the year ended September 30, 2006. It should be read in conjunction with the unaudited interim consolidated financial statements for the three month period ended December 31, 2006 and our audited consolidated financial statements for the year ended September 30, 2006. The interim statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") for interim financial information, but they have been subject to neither an audit nor a review by the Company's auditors.

Note Regarding Forward-looking Statements

The MD&A contains forward-looking statements which reflect the Company's current expectations regarding future events. The forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "estimate", "expect", "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions. These forward-looking statements involve risk and uncertainties, including the difficulty in predicting product approvals, acceptance of and demands for new products, the impact of the products and pricing strategies of competitors, delays in developing and launching new products, the regulatory environment, fluctuations in operating results and other risks, any of which could cause results, performance, or achievements to differ materially from the results discussed or implied in the forward-looking statements. Many risks are inherent in the industry; others are more specific to the Company. Investors should consult the "Risk Factors" section of this MD&A as well as the Company's ongoing quarterly filings for additional information on risks and uncertainties relating to these forward-looking statements. Investors should not place undue reliance on any forward-looking statements. Management assumes no obligation to update or alter any forward-looking statements whether as a result of new information, further events or otherwise.

Nature of the Business

Covalon is a biotechnology company that has developed and patented advanced therapeutic biomaterials and medical coatings for advanced wound care, surgical applications and coatings that inhibit microbial invasion for helping to reduce infections. The anti-microbial silver ion-releasing technology has been shown to be effective against many microbes including antibiotic resistant bacteria such as methicillin resistant Staphylococcus (MRSA), vancomycin resistant Enterococcus (VRE), yeasts and other microbes. The Company's core competencies in polymer chemistry and surface coatings have been combined to generate several proprietary technologies that create a range of time-release drug delivery platforms that can be applied to many medical devices for treating unmet medical needs. The Company creates drug-device combination products that deliver antimicrobial silver ions for helping to reduce hospital acquired infections. The Company intends to develop its collagen-based scaffolds to deliver other therapeutics for inducing hemostasis, as well as treating disease related to ischemic diseases. The Company acquired EPAS1 technology that is intended to be used in developing a genetic based approach to wound healing and congestive heart failure. EPAS1 technology relies on hypoxia inducible-factor-activity to stimulate angiogenesis for regenerative medicine. The technology is complimentary to Covalon's wound healing program. The Company identified unmet medical needs and has developed products, received regulatory approval and is manufacturing products that contain antimicrobial silver ion that have been shown to reduce microbial attachment and invasions. The Company is generating revenue and has a strong pipeline of products that are increasingly sophisticated.

Covalon Collagen Materials

Covalon collagen materials are bioresorbable collagen-based devices developed by the Company for delivery of therapeutics ranging from antimicrobial silver technology to cell therapy. The technology allows the Company to produce a variety of advanced convergent technology drug-devices including anti-infective wound dressings and cellular scaffolds for tissue regeneration. The Company's initial focus with scaffolds is to develop, license and/or sell a series of OEM manufactured silver ion releasing collagen-based wound dressings that reduce bacterial contamination of chronic wounds, such as diabetic ulcers, bed sores, trauma wounds, burns and other conditions in which a wound presents with recalcitrant healing. Improvements to the Company's wound dressings offerings have generated FDA

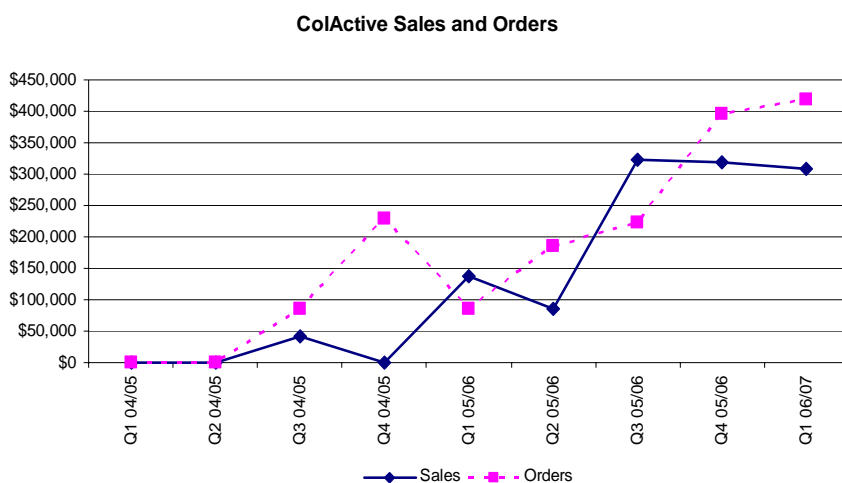


approved products that improve wound care by inactivating wound bed enzymes that are known to result in slow to heal wounds.

Current Collagen Products

Covalon has received FDA (510K) pre-market approvals on its collagen dressing (April 27, 2005), on its anti-microbial collagen dressing (June 06, 2005), on its hydrated anti-microbial collagen dressing (February 07, 2006) and on its advanced wound dressings with matrix metalloprotease (MMP) inhibiting activity (April 26, 2006). The following is a list of products developed by Covalon and approved for sale in the US and Canada.

Product	Regulatory Approval	Distribution	Launch
ColActive	FDA (April 27, 2005) Health Canada	Hartmann-Conco	June 2005
ColActiveAg	FDA (June 06, 2005) Health Canada	Hartmann-Conco	August 2005
CovaClearAg	FDA (February 07, 2005) Health Canada submitted	to be determined	Projected Q3 2007
Collagran	FDA (April 26, 2006) Health Canada submitted	to be determined	Projected Q3 2007
Collagran+	FDA (April 26, 2006) Health Canada submitted	to be determined	Projected Q3 2007
CollagranAg+	FDA (April 26, 2006) Health Canada submitted	to be determined	Projected Q3 2007



The Company launched the ColActive wound dressing line through Hartmann-Conco, Inc. of the US, late in the third quarter of 2005. End user response has been good and sales orders have grown month over month. A number of clinical cases have been documented that show ColActive's excellent performance on difficult to heal wounds. Clinicians are recommending the ColActive products for recalcitrant wounds. The chart left shows the growth in orders versus sales of ColActive since the product was launched. In the first quarter of Covalon's fiscal year 2007, orders outpaced sales and based on distributor feedback this is expected to continue for the next quarter. Validation of new capacity, planned for April 2007, will allow fulfillment of the increasing order trend.

Collagen Technology Pipeline

Covalon has identified a number of product applications for its collagen-based technology platform. The applications are increasingly more sophisticated in therapeutic delivery and functions. The Company's goal is to take advantage of the collagen platform as an advanced combination device for delivery of certain therapeutics and cells. The current

pipeline of collagen devices includes topical hemostatic dressings, a rapid hemostatic trauma dressing, a biologics delivery device for hormones and growth factors, and EPAS1 altered cells engineered for modulating angiogenesis. Angiogenesis is integral to regenerative medicine, including wound healing, treating ischemic heart disease, peripheral vascular disease as well as having other applications.

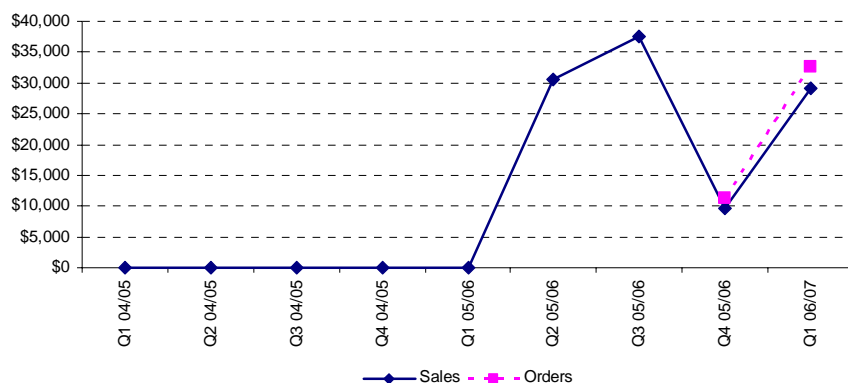
The following chart outlines the various collagen applications under development.

Application	Design Phase	Prototype	Process / Production Scale up	Animal Testing	Regulatory Approval
Hemostatic dressing	Completed	Completed	Completed	In process	Projected filing Q3 – Q4 2007
Hemostatic dressing delivering PLT	In process	-	-	-	-
Hemostatic delivering FNS	In process	-	-	-	-
EPAS1 Cell for Tissue Regeneration	In process	-	-	-	-

Coatings

Covalon has developed an advanced proprietary coating platform for the emerging combination device market. The technology uses a proprietary ultraviolet light-mediated process to create biocompatible surface coatings capable of carrying a number of therapeutics. The initial focus is to use the platform for delivery of antimicrobial ionic silver from medical devices, such as Foley catheters where the risk of catheter associated infection in hospitals is high. The coating can be applied to many devices, including vascular access catheters, IV lines, hemodialysis lines and pain management ports.

Coating Revenue



Current Coating Products

FDA (510K) approval was received on Covalon's silver ion releasing coating for Foley catheters on February 20, 2006. The Company provides coating services for Medline Industries, one of the largest distributors in the US. Medline launched the "Silvertouch" Foley catheter in June 2006. Initial response has been good as many US hospitals are looking for alternatives. This graph depicts the quarter by quarter growth in coating revenues for the past two years. The first quarter of Covalon's fiscal year 2007 shows an improvement over quarter 4 of Covalon's fiscal year 2006. The distributor recently launched a promotion to open new accounts so the trend in sales should continue to improve.



Coating pipeline

During the recent quarter the Company provided prototype coated samples for a number of new customers for a variety of other applications including: peripherally inserted central catheters (PICCS), central venous lines (CV lines), sutures, intravenous lines (IV lines), feeding tubes, stomach anchors, stents and metal for orthopedic applications. The Company is in “fee for service” early stage co-development with a number of customers for these coating applications. The following chart outlines the status of coating applications under development.

Application	Design Phase	Prototype	Process / Production Scale up
Central venous lines	Completed	Completed	-
PICC lines	Completed	Completed	-
Sutures	Completed	Completed	-
IV lines	In process	-	-
Stomach anchors	Completed	-	-
Stents	In process	-	-
Catheter ports	In process	-	-
Metals for orthopedics	In process	-	-

The Company intends to expand its coating services business by marketing its technology platform to medical device companies for the development of combination devices. This includes a continued focus on antimicrobial applications and integration of other therapeutics into the coating. The Company has identified development parties and intends to develop business relationships.

Overview of Financings

Covalon is publicly traded company listed on the Toronto Venture Exchange (TSXV) trading under the symbol (COV).

The table below sets out the number of issued and outstanding common shares as well as the number of issued and outstanding warrants and options to purchase common shares, in each case as at December 31, 2006.

Common shares	56,572,784
Options to purchase common shares	2,853,082
Broker Compensation Warrant Units	1,095,728 ¹
Series III Warrants to purchase common shares	13,696,600 ²

1 The Broker compensation warrant units entitle the holder to acquire at any time until 4:00 p.m. (Toronto time) on September 22, 2007 (“expiry time”) units in the capital of the Company. Each unit entitles the holder to purchase one unit, each unit consisting of one common share and one common share purchase warrant (“warrant”) at a price of \$0.50 per unit up and until the expiry time. Each warrant entitles the holder to purchase an additional common share at \$0.75 per warrant up and until the expiry time.

2 The Series III warrants entitle the holder to acquire at any time until 4:30 p.m. (Toronto time) on September 22, 2007 (“expiry time”) one fully paid and non-assessable common share in the capital of Covalon Technologies Ltd. at an exercise price of \$0.75 per common share for each warrant.

Covalon became a publicly listed company on the Toronto Venture Exchange on December 21, 2004. At the beginning of the current fiscal year, October 01, 2006, the Company had 56,322,784 common shares issued and outstanding.

The following summarizes the Company's financings through equity transactions for the current year:

Date of issuance	Equity Issued
November 13, 2006	150,000 options to purchase common shares with a value of \$9,300 were exercised for cash consideration of \$60,000.
December 15, 2006	100,000 options to purchase common shares with a value of \$15,200 were exercised for cash consideration of \$40,000.

Significant Operational Milestones

Covalon achieved significant milestones for the period from October 01, 2006 to December 31, 2006.

- Covalon sales orders for wound dressings continue to increase on a quarter by quarter basis. The Company is continuing to secure increased capacity through its OEM suppliers. By April the capacity should be double the current sales order requirements. The Company is continuing to plan further increases in capacity over the year as it expands its distribution.
- The Company completed the acquisition of technology from Profusion Therapeutics Inc. The Company acquired a cell engineering platform for improving blood vessel development (angiogenesis). The technology uses endothelial PAS domain protein (EPAS1). EPAS1 is the subject of several US and European patent applications that Covalon has assumed through the acquisition. EPAS1 is a naturally occurring hypoxia-inducible transcription factor that is predominantly expressed in endothelial cells such as those lining the walls of blood vessels. Covalon has initiated a gene therapy program with the development and potential commercialization of EPAS1 for inducing angiogenesis.
- Covalon successfully applied its hydrophilic antimicrobial silver ion releasing coating to stainless steel. This development allows the Company to further develop its antimicrobial technology for orthopedic trauma and orthopedic surgical applications. Opportunities for the Company includes hip, knee, shoulder, external and internal fracture fixation and stabilization. The development fits precisely with Covalon's strategy to deter infection and improve patient outcomes.

According to Medtech Insight's Market & Technology Report: Trends and Opportunities in U.S. Orthopedic Markets for implant, Reconstruction and Trauma products, in 2004 the total market for orthopedic products for implant, reconstruction, and trauma applications was estimated to be \$11.5 billion; sales are expected to double to approximately \$23 billion by the year 2012.

- Covalon hired an experienced Regulatory / Clinical Affairs and Quality Systems Director. This person has more than twenty years experience and will help to guide the Company's future products through the complicated regulatory environment.

Covalon acquired the technology from Profusion Therapeutics for 1,100,000 fully paid non-assessable common shares of Covalon Technologies Ltd., in escrow, to be released on various success milestones. The Company estimates 75,000 shares to be released from escrow in 2007. Covalon has agreed to fund the development of EPAS1 through various milestones and a budget of \$375,000 has been committed to by Covalon for the 12 month period ending September 30, 2007. A budget will be established on a year by year basis for the development of EPAS1 technology that depends on the successful completion of each successive development milestone.



Results of Operations

Revenues for Q1

The financial results for the three month periods for the current and prior year are summarized below.

<i>(in Canadian \$)</i>	Three months ended December 31, 2006	Three months ended December 31, 2005
Revenues		
Product sales	337,767	137,093
Other income	52,528	2,961
Total Revenue	390,295	140,054
Expenses		
Cost of goods sold	198,767	61,707
Administrative expenses	592,899	520,830
Total Expenses	791,666	582,537
Net Income (loss)	(401,371)	(442,483)
Income (loss) per share	(.007)	(.01)

Revenue

Total product revenues in Q1 2007 were \$337,767, an increase of 2.45 times product revenues for Q1 2006. As the Company completes the validation of its new capacity and new wound care products, the lead time on completion of sales orders is expected to decrease and sales to increase.

The revenue results for the three month periods for the current and prior years are summarized below.

<i>(in Canadian \$)</i>	Three months ended December 31,		
	2006	2005	change
Sales			
Wound care	308,549	137,093	171,456
Coated catheters	29,218	0	29,218
Coating services			
Other Revenue			
Investment income	51,167	1,600	49,567
Licensing fees	1,361	1,361	0
Total	390,295	140,054	250,241

Wound Care Sales

Wound care sales increase by \$171,456 for Q1 2007 compared to Q1 2006. The Company received wound care sales orders of \$419,069 for the period – this was a record. The clinicians who have tried the ColActive products have experienced positive results on challenging wounds. These results are translating into demand for the products. The Medicare / Medicaid reimbursement for the ColActive line should lead to a continued “ramp up” in sales. The Company is exploring expanded distribution opportunities with the goal of securing faster global market penetration.

Coatings

Coating sales for Q1 2007 were \$29,218. The distributor, Medline Industries, has launched a sales promotion to secure a number of trial centres across the USA. Sales are expected to improve as the trials are completed and accounts converted. To date Medline has reported that a majority of its initial accounts have re-ordered. This is a positive trend as they move through account trials.

Investment Income

Investment income increased as a result of the increase in cash available for investments. All investments are made in accordance with the Company's audit committee investment guidelines.

Expenses

Covalon administrative and overhead expenses increased in total by \$72,069 in Q1 2007. The increase was primarily due to staff additions in marketing and regulatory affairs. Key staff members were added as part of the Company's distribution expansion into non-domestic markets. The investment in personnel was required to achieve the expansion.

The expenses for Q1 for 2007 and 2006 are summarized below.

<i>(in Canadian \$)</i>	Three months ended December 31,		
	2006	2005	Change
Cost of Goods Sold	198,767	61,707	137,060
Administrative and overhead			
Amortization	62,838	30,606	32,232
Bank Charges and interest	1,553	731	822
Consulting fees	0	13,203	(13,203)
Director fees	21,366	22,500	(1,134)
Foreign currency (gain) loss	192	(725)	920
Management fees	77,500	77,500	0
Marketing	93,188	30,216	62,972
Office and administrative	99,333	81,923	17,410
Patent maintenance	200	49	151
Professional fees	14,146	20,983	(6,837)
Property Maintenance	1,440	1,440	0
Regulatory	83,053	48,614	34,439
Research & Development	115,456	162,789	(47,333)
Training	9,606	847	8,759
Travel	13,028	30,154	(17,126)
Total	592,899	520,830	72,069

Cost of Goods Sold

The cost of goods sold for Q1 in 2007 remained constant at 58% of sales, compared to Q4 2006. The current production and packaging flows are being modified to reduce the labor intensity of the process which is currently about 70% of the processing costs. The changes being implemented are directed at cutting processing time by up to 60%.

Amortization

The amortization expense increase was primarily due to the addition of amortization of deferred development costs for \$28,850. In Q1 2006 there was no amortization of deferred development costs.

Bank and interest charges

Bank and interest charges for Q1, 2007 increased by \$822 over Q1 2006. The increase was the result of an increase in bank rates and an increase in the number of U.S. transactions.



Consulting Fees

Consulting fees for the period declined by \$13,203 compared to Q1 2006. No consultants were engaged for Q1 2007 all the regulatory work was done internally by the Company.

Director Fees

The Director fees declined by \$1,134 in Q1 2007 as a result of the fewer committee meetings being held

Management Fees

The Management fees for the Company were unchanged for Q1, 2007. The management did not take salary increases but instead agreed to performance based compensation

Marketing

Marketing expenses increased in Q1 2007, as a result of the Company hiring a sales representative for the Canadian market and a marketing manager

Office and Administration

Office and administration costs increased in Q1 2007 by 17,410. A majority of this increase reflects the addition of one new accounting staff member.

Cash Flows

The cash flow for the three month periods for 2006 and 2007 is summarized below.

<i>(in Canadian \$)</i>	For the three months ended	
	2006	December 31 2005
Cash flow from operations	(487,799)	(465,635)
Cash flow from investing activities	(58,899)	(39,858)
Cash flow from financing activities	100,000	0
Increase (decrease)	(446,890)	(504,768)

Cash Flow from Operations

Cash flow uses of funds for Covalon in Q1, 2007 consisted primarily of \$401,371 in operating losses, an increase of \$92,908 in accounts receivable and an increase of \$50,918 in inventory.

Cash Flow from Investing Activities

Cash flow uses from investing activities mostly consisted of costs associated with acquisition patents and patent application filings.

Cash Flows from Financing Activities

Cash flow from financing activities resulted in net proceeds of \$100,000 from the exercise of 250,000 options to purchase 250,000 common shares.

Professional Fees

Professional fees decreased by \$6,836 in Q1 2007 as a result of savings realized from investment in the prior year to develop standardized contracts which would allow the Company to draft many of its own agreements for review by counsel.

Regulatory Expense

The majority of the increase of \$34,439 in regulatory expense was related to the addition of an experienced Director of Regulatory Affairs, Quality Affairs and Clinical Affairs. The Company increased the compensation for this position to attract a senior level candidate. In addition the TSXV increased its filing fees.

Research and Development

Research and Development expenses decreased by \$47,333 in Q1 2007 compared to Q1 2006, because of a decrease in outside testing.

Travel Expense

Travel expenses decreased in Q1 for the 2007 compared to Q1 in the prior year. Less travel was required to deal with OEM manufacturing issues related to production.

Liquidity and Capital Resources

As at December 31, 2006 the Company had a current ratio of 9.17 (current assets to current liabilities). The working capital consisted of cash of \$4,564,752, trade receivables of \$325,061, recoverable investment tax credits of \$65,400, inventory of \$320,317 and prepaid expenses of \$129,553 against \$570,031 in trade payables.

With in excess of \$4.56 million in cash and marketable securities, the Company has the financial resources to internally finance its revenue growth strategy.

Subsequent Events

Subsequent to December 31, 2006 no material event occurred.

Risks and Uncertainties

An investment in the securities of the Company is speculative due to the proposed nature of the Company's business and the present stage of Covalon's development. Consequently, an investment in the Company is subject to certain risks and investors should not invest in securities of the Company unless they can afford to lose their entire investment. In addition to the factors disclosed elsewhere in this MD&A, investors should consider the following risk factors in assessing the investment merits of such securities.

Biotechnology companies in the early revenue stage are subject to a number of risks and uncertainties that are inherent to the development of any new technology. General business risks include, among other things, uncertainty in product development and related clinical trials, the regulatory environment including delays or denial of approval to market products, the impact of technological change and competing technologies, the ability to protect and enforce its patent portfolio and intellectual property assets, the availability of capital to finance continued and new product development, the ability to secure strategic collaborators and its reliance on these collaborators for the development, regulatory approval, testing, manufacturing and commercialization of its products and the risk of product liability claims. In addition, market prices for securities of biotechnology companies are generally volatile, and may or may not move in a manner consistent with the progress being made by such company. To the extent possible, the Company's management pursues and implements strategies to reduce or mitigate the risks and uncertainties associated with its business. See "Information concerning the Resulting Issuer – Risk Factors" outlined in Seder Capital Corp.'s Filing Statement dated December 9, 2004 and available for review on SEDAR at www.sedar.com.

Additional Information

Additional information relating to the Company can be found on SEDAR at www.sedar.com.