

CHIRAL QUEST INC
Form 424B3
August 19, 2004

Filed Pursuant to Rule 424(b)(3)
File No. 333-113980

PROSPECTUS SUPPLEMENT NO. 2
(To Prospectus Dated April 26, 2004)

VioQuest Pharmaceuticals, Inc.
(formerly known as Chiral Quest, Inc.)

7,723,041 Shares

Common Stock

The information contained in this prospectus supplement amends and updates our prospectus dated April 26, 2004 (the Prospectus), and should be read in conjunction therewith. Please keep this Prospectus Supplement with your Prospectus for future reference.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the Prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this Prospectus Supplement is August 16, 2004

Forward-Looking Statements

Certain statements contained in this prospectus supplement that are forward-looking in nature are based on the current beliefs of our management as well as assumptions made by and information currently available to management, including statements related to the markets for our products, general trends in our operations or financial results, plans, expectations, estimates and beliefs. In addition, when used in this prospectus, the words may, could, should, anticipate, believe, estimate, expect, intend, plan, predict and similar expressions as they relate to us or our management, may identify forward-looking statements. These statements reflect our judgment as of the date of this prospectus supplement with respect to future events, the outcome of which are subject to risks, which may have a significant impact on our business, operating results or financial condition. You are cautioned that these forward-looking statements are inherently uncertain. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results or outcomes may vary materially from those described herein. We undertake no obligation to update forward-looking statements. The risks identified under the heading Risk Factors in the Prospectus, among others, may impact forward-looking statements contained in this prospectus supplement.

Restructuring

On August 12, 2004, we changed our name to VioQuest Pharmaceuticals, Inc. and created a new wholly owned subsidiary, VioQuest Drug Development, Inc. which will concentrate on acquiring, developing and commercializing human therapeutics. In addition, we have assigned substantially all of our operating and technology assets relating to our proprietary chemical catalysis platform to a second wholly owned subsidiary, which will be re-named Chiral Quest, Inc. Chiral Quest will continue to aggressively pursue our current business plan to commercialize our chiral catalyst technology. Additionally, Ronald Brandt has been named President and CEO of our chiral catalyst business (the newly named Chiral Quest, Inc.) and will remain Interim President and CEO of our parent company.

Interim Financial Statements Quarter Ended June 30, 2004

Included in this prospectus supplement beginning at page F-1 are our interim financial statements as of and for the three and six months ended June 30, 2004, included the accompanying footnotes thereto. These interim financial statements, which were included in our Quarterly Report on Form 10-QSB for the quarter ended June 30, 2004, should be read in conjunction with the audited financial statements as of and for the year ended December 31, 2003 that were included in the Prospectus.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations is derived from our Quarterly Report on Form 10-QSB for the quarter ended June 30, 2004. We have not attempted to update this discussion in any way. You should read the following discussion in conjunction with our condensed consolidated financial statements as of and for the three and six months ended June 30, 2004 included in this prospectus supplement, as well as our consolidated financial statements and related notes included in the Prospectus.

Overview

Since our inception in October 2000, we have focused our efforts and resources on the development of asymmetric catalysis technology, our primary intellectual property to which we hold an exclusive worldwide license from the Pennsylvania State Research Foundation (PSRF), the technology development arm of the Pennsylvania State University (Penn State). Our license from PSRF covers certain inventions discovered by our Chief Technology Officer (CTO) prior to November 8, 2002.

Since inception we have incurred an accumulated deficit of \$5,434,021 through June 30, 2004. We expect our operating losses to increase significantly over the next several years, primarily due to expansion of our research and development programs, the hiring of additional chemists, and the expansion of our manufacturing capabilities.

Our ability to achieve profitability depends upon, among other things, our ability to discover and develop products (specifically new ligands which are the Company's core proprietary technology consisting of molecular compounds that create a chiral center), and to develop our products on a commercial scale through a cost effective and efficient process. To the extent that we are unable to produce, directly or indirectly, ligands in quantities required for commercial use, we will not realize any significant revenues from our technology. Moreover, there can be no assurance that we will ever achieve significant revenues or profitable operations from the sale of any of our products or technologies.

Since our inception, we have generated sales revenue but no net profits. Our management believes that our research and development (R&D) and manufacturing capacity will need to grow in order for us to be able to obtain significant licensing and manufacturing agreements with large fine chemical and pharmaceutical companies. We believe that our manufacturing capacity will continue to be enhanced with the expansion of our new office and laboratory space located in Monmouth Junction, New Jersey that was leased in June 2003.

On February 18, 2003, we acquired Surg II, Inc., a Minnesota corporation (Surg), in a reverse merger transaction (the Merger). Pursuant to the terms of the Merger, Chiral Quest, LLC merged with and into a wholly-owned subsidiary of Surg. In exchange for all of the outstanding membership interests of Chiral Quest, LLC, Surg issued to the former member of Chiral Quest, LLC a number of shares of Surg's common stock that resulted in the members of Chiral Quest, LLC owning two-thirds of Surg's outstanding shares following the Merger. In connection with the Merger, Surg changed its name to Chiral Quest, Inc., a Minnesota corporation, and adopted the business plan of Chiral Quest, LLC. Accordingly, when we refer to our business or financial information relating to periods prior to the Merger, we are referring to the business and financial information of Chiral Quest, LLC, unless the context indicates otherwise. In August 2004, we changed the Company's name to VioQuest Pharmaceuticals, Inc.

Results of Operations For the Three Months Ended June 30, 2004 vs. 2003

Our revenues for the three months ended June 30, 2004 were \$357,200 as compared to \$59,382 for the three months ended June 30, 2003. For the three months ended June 30, 2004, approximately 8% of total revenue was derived from the amortization of option fee income pertaining to the licensing of our intellectual property and 92% of total revenue was derived from sales of our ligands, feasibility screening and customized process development services sold to third parties. For the three months ended June 30, 2003, approximately 56% of total revenue was derived from the amortization of option fee income and 46% of total revenue was comprised of sales of our ligands. It is anticipated that sales of our ligands, molecular building blocks and customized chiral services will continue to comprise a greater percentage of our revenues in the future as we expand our manufacturing capabilities.

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Cost of goods sold for three months ended June 30, 2004 was \$294,188 as compared to \$7,528 during the three months ended June 30, 2003. The increase in cost of goods sold is attributable to the materials used in production for projects completed and shipped along with the allocation of direct labor and overhead expenses to finished goods.

Management and consulting expenses for the three months ended June 30, 2004 were \$124,660 as compared to \$71,335 during the three months ended June 30, 2003. The overall change for the three months ended June 30, 2004 vs. June 30, 2003 was primarily caused by an increase in consulting expense. Consulting expense increased due to the new consulting agreement we entered into with our CTO at a rate of \$10,000 per month effective May 15, 2003, along with the Company utilizing the consulting services of a previous employee during the second quarter 2004. In addition, consulting expense increased due to the amortization of the fair value of stock options issued to consultants and scientific advisory board members, during the second, third, and fourth quarters of 2003.

Our R&D expenses for the three months ended June 30, 2004 were \$205,946 as compared to \$110,242 during the three months ended June 30, 2003. This increase was primarily caused by increased utilization of the Penn State research resources in connection with the development of new ligands. The agreement with Penn State, which has been extended to October 14, 2004, provides for the Company to fund services of four post-doctorate fellows whom under the supervision of the CTO, conduct research and provide research quantities of chiral ligands to the Company. The future obligation payable by the Company through October 14, 2004 as of the end of the agreement is approximately \$73,000. This amount consists principally of four post-doctorate salaries, fringe benefits, materials and supplies for the stated period. In addition, during the second quarter of 2003, we opened an additional laboratory facility in New Jersey, and have completed an expansion to the facility in April 2004, that enabled us to produce both research and commercial quantities of our ligands. In connection with the new facility and its expansion, numerous lab supplies and chemicals were purchased. Accordingly, we incurred increased expenses in the second quarter due to the opening and expansion of the New Jersey facility, along with the increased costs of using the facility and chemists at Penn State.

Selling, general and administrative (SG&A) expenses for the three months ended June 30, 2004 were \$388,330 as compared to \$259,882 during the three months ended June 30, 2003. This increase in SG&A expenses was due in part to establishing contract reserves, increased usage of temporary contractors, higher legal and accounting fees, increased rent expense for the New Jersey facility as a result of the facility s expansion, additional spending on advertising and promotion expenses, increased travel expenses for new business development opportunities and higher administrative expenses associated with having more employees such as insurance and employer payroll taxes.

Compensation expense was \$574,293 for the three months ended June 30, 2004 as compared to \$146,595 for the three months ended June 30, 2003. This increase was caused primarily by the resignation of the CEO effective April 16 2004, which resulted in a charge of \$375,000 in severance costs. In addition, compensation expense increased due to the hiring of a vice president of business development, a controller, and several chemists to work at the new laboratory facility in New Jersey. Compensation expense as it relates to direct labor for ongoing and completed projects, has been capitalized as part of inventory work in process and finished goods as these cost components relate directly to cost of goods sold.

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Depreciation and amortization expenses for the three months ended June 30, 2004 were \$62,608 as compared to \$32,716 during the three months ended June 30, 2003. This increase was primarily related to fixed asset purchases for office equipment, computer equipment, laboratory equipment and leasehold improvements for the newly leased facility and expansion in New Jersey.

Interest income for the three months ended June 30, 2004 was \$11,100 as compared to \$4,730 for the three months ended June 30, 2003. The increase in interest income is attributed to having higher cash reserves as a result of the funds received from the private placement of the Company's common stock in February 2004.

Our net loss for the three months ended June 30, 2004 was \$1,281,725 as compared to \$564,186 for the three months ended June 30, 2003. The increased net loss for the three months ended June 30, 2004 as compared to June 30, 2003 was primarily due to the severance costs associated with the resignation of the Company's CEO in April 2004, higher R&D expenses incurred with funding Penn State's research services provided to the Company, increased operational expenditures comprised of higher total rent expense due to the newly leased, and expanded New Jersey facility in June 2003 and April 2004 respectively, higher legal and accounting expenses, higher payroll expenses associated with having more employees along with increased usage of temporary contractors, along with the establishment of contract reserves. We expect losses to continue and increase in the next year as we attempt to expand our laboratory space.

Results of Operations For the Six Months Ended June 30, 2004 vs. 2003

Our revenues for the six months ended June 30, 2004 were \$735,123 as compared to \$131,441 for the six months ended June 30, 2003. For the six months ended June 30, 2004, approximately 8% of total revenue was derived from the amortization of option fee income pertaining to the licensing of our intellectual property and 92% of total revenue was derived from sales of our ligands, feasibility screening and customized process development services sold to third parties. For the six months ended June 30, 2003, approximately 51% of total revenue was derived from the amortization of option fee income and 49% of total revenue was comprised of sales of our ligands. It is anticipated that sales of our ligands, molecular building blocks and customized chiral services will continue to comprise a greater percentage of our revenues in the future as we expand our manufacturing capabilities.

Cost of goods sold for the six months ended June 30, 2004 was \$377,249 as compared to \$25,387 during the six months ended June 30, 2003. The increase in cost of goods sold is attributable to the materials used in production for projects completed and shipped along with the allocation of direct labor and overhead expenses to finished goods.

Management and consulting expenses for the six months ended June 30, 2004 were \$237,892 as compared to \$126,009 during the six months ended June 30, 2003. The overall change for the six months ended June 30, 2004 vs. June 30, 2003 was primarily caused by an increase in consulting expense. Consulting expense increased due to the new consulting agreement we entered into with our CTO at a rate of \$10,000 per month effective May 15, 2003, along with the Company utilizing the consulting services of a previous employee during the second quarter 2004. In addition, consulting expense increased due to the amortization of the fair value of stock options issued to consultants and scientific advisory board members, during the second, third and fourth quarters of 2003. The increased management and consulting expenses have been offset by a decrease in management expenses, charged by Paramount BioCapital LLC, for administrative services which are no longer required by the Company.

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Our R&D expenses for the six months ended June 30, 2004 were \$458,050 as compared to \$206,475 during the six months ended June 30, 2003. This increase was primarily caused by increased utilization of the Penn State research resources in connection with the development of new ligands. The agreement with Penn State, which has been extended to October 14, 2004, provides for the Company to fund services of four post-doctorate fellows who, under the supervision of the CTO, conduct research and provide research quantities of chiral ligands to the Company. The future obligation payable by the Company through October 14, 2004 as of the end of the agreement is approximately \$73,000. This amount consists principally of four post-doctorate salaries, fringe benefits, materials and supplies for the stated period. In addition, during the second quarter of 2003, we opened an additional laboratory facility in New Jersey, and have completed an expansion to the facility in April 2004, that enabled us to produce both research and commercial quantities of our ligands. In connection with the new facility and its expansion, numerous lab supplies and chemicals were purchased. Accordingly, we incurred increased expenses for the six months ended June 30, 2004, due to the opening and expansion of the New Jersey facility, along with the increased costs of using the facility and chemists at Penn State.

Selling, general and administrative (SG&A) expenses for the six months ended June 30, 2004 were \$804,072 as compared to \$423,366 during the six months ended June 30, 2003. This increase in SG&A expenses was due in part to establishing contract reserves, increased usage of temporary contractors, higher legal and accounting fees, increased rent expense for the New Jersey facility as a result of the facility s expansion, additional spending on advertising and promotion expenses, increased travel expenses for new business development opportunities and higher administrative expenses associated with having more employees such as insurance and employer payroll taxes.

Compensation expense was \$803,878 for the six months ended June 30, 2004 as compared to \$217,720 for the six months ended June 30, 2003. This increase was caused primarily by the resignation of the CEO effective April 16 2004, which resulted in charge of \$375,000 in severance costs. In addition, compensation expense increased due to the hiring of a vice president of business development, a controller, and several chemists to work at the new laboratory facility in New Jersey.

Compensation expense as it relates to direct labor for ongoing and completed projects, has been capitalized as part of inventory work in process and finished goods as these cost components relate directly to cost of goods sold.

Depreciation and amortization expenses for the six months ended June 30, 2004 were \$92,605 as compared to \$42,640 during the six months ended June 30, 2003. This increase was primarily related to fixed asset purchases for office equipment, computer equipment, laboratory equipment and leasehold improvements for the newly leased facility and expansion in New Jersey. Additionally, the Company recognized a one time charge to the amortization of patents for approximately \$13,000. This adjustment to patent amortization was based upon properly accounting for the amortization of a patents legal life of 17 years from the prior amortization of 20 years.

Interest income for the six months ended June 30, 2004 was \$15,807 as compared to \$7,680 for the six months ended June 30, 2003. The increase in interest income is attributed to having higher cash reserves as a result of the funds received from the private placement of the Company s common stock in February 2004.

Our net loss for the six months ended June 30, 2004 was \$2,022,816 as compared to \$902,476 for the six months ended June 30, 2003. The increased net loss for the six months ended June 30, 2004 as compared to June 30, 2003 was primarily due to the severance costs associated with the resignation of the Company s CEO, higher R&D expenses incurred with funding Penn State s research services provided to the Company, increased operational expenditures comprised of higher total rent expense due to the newly leased, and expanded New Jersey facility in June 2003 and April 2004 respectively, higher legal and accounting expenses, higher payroll expenses associated with having more employees along with increased usage of temporary contractors, along with the establishment of contract reserves. We expect losses to continue and increase in the next year as we attempt to expand our laboratory space.

Liquidity and Capital Resources

As of June 30, 2004, we had working capital of \$4,792,040 and cash and cash equivalents of \$5,258,622. If we are unable to significantly increase our revenues, we may require additional financing as early as the second quarter of 2005 in order to continue operations. The most likely source of financing includes private placements of our equity or debt securities or bridge loans to the Company from third party lenders.

The Company's net cash used in operating activities for the six months ended June 30, 2004 was \$1,892,997. The Company's net cash used in operating activities primarily consisted of a net loss of \$2,022,816, an increase in accounts receivable of \$117,300 and decreases in accrued expenses and deferred revenue of \$46,362 and \$143,745, respectively, offset by an increase in accounts payable of \$180,648.

The Company's net cash used in investing activities for the six months ended June 30, 2004 totaled \$249,129, which consisted of purchases of property and equipment primarily used in the New Jersey facility, along with patent application expenditures.

The Company's net cash provided by financing activities for the six months ended June 30, 2004 was \$6,741,631, which was the result of funding provided through the private placement of the Company's common stock.

Management believes that the capital resulting from the private placement will provide sufficient resources to fund our continued operational expansion and corporate development through approximately the second quarter of 2005. Our long term liquidity is contingent upon achieving increased sales and/or obtaining additional financing.

Our working capital requirements will depend upon numerous factors, including, without limitation, the progress of our R&D programs, the resources we devote to developing manufacturing and marketing capabilities, technological advances, the status of competitors, and our ability to establish sales arrangements with new customers. Working capital will also be affected by the expansion of office and laboratory space lease agreements that were entered into during the second quarter of 2003 and first quarter of 2004, along with the hiring of additional employees, in addition to the establishment and funding of the China subsidiary.

We have formed two China subsidiaries through which we intend to open a laboratory facility in the People's Republic of China. We have provided \$66,000 of capital to the China subsidiary during the second quarter of 2004. Our management believes that by opening a facility in China to produce non-proprietary chemical building blocks and related compounds, we will be able to significantly decrease our manufacturing costs and expenses, enabling us to cost-effectively produce our ligands and end products and make our products substantially more competitive and even more attractive to current and potential customers. We expect operations to commence on a limited basis by the end of fiscal 2004.

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VIOQUEST PHARMACEUTICALS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2004 (UNAUDITED) AND DECEMBER 31, 2003

| | <u>JUNE 30, 2004</u> (Unaudited) | <u>December 31,</u> <u>2003</u> |
|--|-------------------------------------|------------------------------------|
| <u>ASSETS</u> | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 5,258,622 | \$ 659,117 |
| Accounts receivable, net of allowance for doubtful accounts of \$8,900 at June 30, 2004 and \$11,490 at December 31, 2003 | 169,005 | 51,705 |
| Inventory | 78,808 | 76,892 |
| Prepaid expenses | 39,850 | 50,052 |
| | <hr/> | <hr/> |
| Total Current Assets | 5,546,285 | 837,766 |
| PROPERTY AND EQUIPMENT, NET | 353,347 | 254,649 |
| SECURITY DEPOSITS | 26,000 | 31,000 |
| DEFERRED FINANCING COSTS | | 50,000 |
| INTELLECTUAL PROPERTY RIGHTS, NET | 488,159 | 412,442 |
| | <hr/> | <hr/> |
| TOTAL ASSETS | \$ 6,413,791 | \$ 1,585,857 |
| | <hr/> | <hr/> |
| <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u> | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 454,062 | \$ 273,414 |
| Accrued expenses | 198,930 | 226,200 |
| Due to related party | | 1,201 |
| Deferred revenue, current portion | 101,253 | 220,592 |
| | <hr/> | <hr/> |
| Total Current Liabilities | 754,245 | 721,407 |
| LONG-TERM LIABILITIES | | |
| Deferred revenue, long-term portion | 14,710 | 39,116 |
| | <hr/> | <hr/> |
| TOTAL LIABILITIES | 768,955 | 760,523 |
| | <hr/> | <hr/> |
| COMMITMENTS AND CONTINGENCIES | | |
| STOCKHOLDERS' EQUITY | | |
| Common stock, \$.01 par value, 50,000,000 shares authorized, 17,827,924 shares issued and outstanding at June 30, 2004 and 13,001,018 shares issued and outstanding at December 31, 2003 | 178,279 | 130,010 |
| Additional paid-in capital | 11,508,715 | 4,865,353 |
| Deferred expenses | (608,137) | (758,824) |
| Accumulated deficit | (5,434,021) | (3,411,205) |
| | <hr/> | <hr/> |
| Total Stockholders' Equity | 5,644,836 | 825,334 |
| | <hr/> | <hr/> |

| | | |
|--|---------------------|---------------------|
| <u>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</u> | \$ 6,413,791 | \$ 1,585,857 |
|--|---------------------|---------------------|

See accompanying notes to condensed consolidated financial statements.

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VIOQUEST PHARMACEUTICALS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2004 AND 2003
(UNAUDITED)

| | For the Three Months Ended June 30, 2004 | For the Three Months Ended June 30, 2003 | For the Six Months Ended June 30, 2004 | For the Six Months Ended June 30, 2003 |
|--|---|---|---|---|
| REVENUE | \$ 357,200 | \$ 59,382 | \$ 735,123 | \$ 131,441 |
| COST OF GOODS SOLD | (294,188) | (7,528) | (377,249) | (25,387) |
| GROSS PROFIT | 63,012 | 51,854 | 357,874 | 106,054 |
| OPERATING EXPENSES | | | | |
| Management and consulting fees | 124,660 | 71,335 | 237,892 | 126,009 |
| Research and development | 205,946 | 110,242 | 458,050 | 206,475 |
| Selling, general and administrative | 388,330 | 259,882 | 804,072 | 423,366 |
| Compensation | 574,293 | 146,595 | 803,878 | 217,720 |
| Depreciation and amortization | 62,608 | 32,716 | 92,605 | 42,640 |
| Total Operating Expenses | 1,355,837 | 620,770 | 2,396,497 | 1,016,210 |
| LOSS FROM OPERATIONS | (1,292,825) | (568,916) | (2,038,623) | (910,156) |
| INTEREST INCOME, NET | 11,100 | 4,730 | 15,807 | 7,680 |
| NET LOSS | \$ (1,281,725) | \$ (564,186) | \$ (2,022,816) | \$ (902,476) |
| NET LOSS PER COMMON SHARE BASIC AND DILUTED | \$ (.07) | \$ (.04) | \$ (.12) | \$ (.08) |
| WEIGHTED AVERAGE SHARES OUTSTANDING BASIC AND DILUTED | 17,827,924 | 13,001,018 | 16,342,722 | 11,937,998 |

See accompanying notes to condensed consolidated financial statements.

VIOQUEST PHARMACEUTICALS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE SIX MONTHS ENDED JUNE 30, 2004
(UNAUDITED)

| | <u>Common Stock</u> | | <u>Additional Paid-In Capital</u> | <u>Deferred Expenses</u> | <u>Accumulated Deficit</u> | <u>Total Stockholders Equity</u> |
|---|---------------------|-------------------|---|------------------------------|--------------------------------|--|
| | <u>Shares</u> | <u>Amount</u> | | | | |
| Balance, January 1, 2004 | 13,001,018 | \$ 130,010 | \$ 4,865,353 | \$ (758,824) | \$ (3,411,205) | \$ 825,334 |
| Private placement of common stock net of expenses of \$57,841 | 4,826,906 | 48,269 | 6,643,362 | | | 6,691,631 |
| Amortization of deferred expenses | | | | 150,687 | | 150,687 |
| Net loss | | | | | (2,022,816) | (2,022,816) |
| Balance, June 30, 2004 | 17,827,924 | \$ 178,279 | \$ 11,508,715 | \$ (608,137) | \$ (5,434,021) | \$ 5,644,836 |

See accompanying notes to condensed consolidated financial statements.

VIOQUEST PHARMACEUTICALS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX MONTHS ENDED JUNE 30, 2004 AND 2003
(UNAUDITED)

| | For the Six Months Ended June 30, 2004 | For the Six Months Ended June 30, 2003 |
|--|---|---|
| | <u> </u> | <u> </u> |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$ (2,022,816) | \$ (902,476) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 92,605 | 42,640 |
| Amortization of deferred expenses | 150,687 | 76,734 |
| Changes in operating assets and liabilities: | | |
| Increase in accounts receivable | (117,300) | (47,874) |
| Increase in inventory | (1,916) | (10,090) |
| Decrease (Increase) in prepaid expenses | 10,202 | (7,985) |
| Decrease (Increase) in security deposits | 5,000 | (20,000) |
| Increase in accounts payable | 180,648 | 98,774 |
| (Decrease) Increase in accrued expenses and due to related party | (46,362) | 83,454 |
| Decrease in deferred revenue | (143,745) | (66,984) |
| | <u> </u> | <u> </u> |
| Net Cash Used In Operating Activities | (1,892,997) | (753,807) |
| | <u> </u> | <u> </u> |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Payments for purchased equipment | (156,850) | (139,297) |
| Payments for intellectual property rights | (92,279) | (30,160) |
| | <u> </u> | <u> </u> |
| Net Cash Used In Investing Activities | (249,129) | (169,457) |
| | <u> </u> | <u> </u> |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Payment of note payable | | (336,625) |
| Cash received in merger and recapitalization | | 3,017,243 |
| Private placement of common stock | 6,741,631 | |
| | <u> </u> | <u> </u> |
| Net Cash Provided By Financing Activities | 6,741,631 | 2,680,618 |
| | <u> </u> | <u> </u> |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 4,599,505 | 1,757,354 |
| CASH AND CASH EQUIVALENTS BEGINNING OF PERIOD | 659,117 | 33,520 |
| | <u> </u> | <u> </u> |
| CASH AND CASH EQUIVALENTS END OF PERIOD | \$ 5,258,622 | \$ 1,790,874 |
| | <u> </u> | <u> </u> |
| Supplemental Schedule of Non-Cash Investing and Financing Activities: | | |
| Reclassification of Deferred Financing Costs to Additional Paid-In Capital | \$ 50,000 | \$ |
| | <u> </u> | <u> </u> |
| Accrual for Intellectual Property Rights | \$ 17,891 | \$ |
| | <u> </u> | <u> </u> |

See accompanying notes to condensed consolidated financial statements.

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VIOQUEST PHARMACEUTICALS, INC. AND SUBSIDIARY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2004

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND LIQUIDITY

(A) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, the financial statements do not include all information and footnotes required by accounting principles generally accepted in the United States of America for complete annual financial statements. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting of only normal recurring adjustments, considered necessary for a fair presentation. Interim operating results are not necessarily indicative of results that may be expected for the year ending December 31, 2004 or for any subsequent period. These unaudited condensed consolidated financial statements should be read in conjunction with the Annual Report on Form 10-KSB of Chiral Quest Inc. and its subsidiary (the Company or Chiral Quest) as of and for the year ended December 31, 2003.

(B) Liquidity

Since the Company's inception, it has generated sales revenue but no net profits. Management believes that the Company's research and development (R&D) and manufacturing capacity will need to grow in order for the Company to be able to obtain significant licensing and manufacturing agreements with large fine chemical and pharmaceutical companies. Management believes that the Company's manufacturing capacity will continue to be enhanced with its new office and laboratory space located in Monmouth Junction, New Jersey that was leased in June 2003.

Since inception, the Company has incurred an accumulated deficit of \$5,434,021 through June 30, 2004. For the three and six months ended June 30, 2004 the Company had net losses of \$1,281,725 and \$2,022,816, respectively. Management expects the Company's operating losses to increase significantly over the next several years, primarily due to the expansion of its R&D programs, the hiring of additional chemists, and the expansion of its manufacturing capabilities. There can be no assurance that the Company will ever be able to operate profitably.

As of June 30, 2004, the Company had working capital of \$4,792,040 and cash and cash equivalents of \$5,258,622. If the Company is unable to significantly increase its revenues, it will most likely require additional financing, perhaps as early as the second quarter of 2005 in order to continue operations. The most likely sources of financing include private placements of the Company's equity or debt securities or bridge loans to the Company from third party lenders.

The Company's net cash used in operating activities for the six months ended June 30, 2004 was \$1,892,997. The Company's net cash used in operating activities primarily consisted of a net loss of \$2,022,816, an increase in accounts receivable of \$117,300 and decreases in accrued expenses and deferred revenue of \$46,362 and \$143,745, respectively, offset by an increase in accounts payable of \$180,648.

The Company's net cash used in investing activities for the six months ended June 30, 2004 totaled \$249,129, which consisted of purchases of equipment for \$156,850 related to the laboratory expansion completed in April 2004, along with patent applications expenditures of \$92,279.

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The Company's net cash provided by financing activities for the six months ended June 30, 2004 was \$6,741,631. Financing activities consisted of the cash received in the private placement of the Company's common stock on February 25, 2004.

Management anticipates that the Company's capital resources will be adequate to fund its operations through June 30, 2005. However, changes may occur that would consume available capital resources before that time. The Company's combined capital requirements will depend on numerous factors, including: competing technological and market developments, changes in our existing collaborative relationships, the cost of filing, prosecuting, defending and enforcing patent claims and other intellectual property rights and the outcome of any potentially related litigation or other dispute, the purchase of additional capital equipment, acquisition of technologies, the establishment and funding of the Chiral Quest, Jiashan, China facility, and the development and regulatory approval progress of its customers' product candidates into which the Company's technology will be incorporated.

Additional capital that may be needed by the Company in the future may not be available on reasonable terms, or at all. If adequate financing is not available, the Company may be required to terminate or significantly curtail its operations, or enter into arrangements with collaborative partners or others that may require the Company to relinquish rights to certain of its technologies, or potential markets that the Company would not otherwise relinquish.

The Company's ability to achieve profitability depends upon, among other things, its ability to discover and develop products (specifically new ligands which are the Company's core proprietary technology consisting of molecular compounds that create a chiral center), and to develop its products on a commercial scale through a cost effective and efficient process. To the extent that the Company is unable to produce, directly or indirectly, ligands in quantities required for commercial use, it will not realize any significant revenues from its technology. Moreover, there can be no assurance that it will ever achieve significant revenues or profitable operations from the sale of any of its products or technologies.

(C) Stock-Based Compensation

The Company accounts for its employee and director stock option plans using the intrinsic value method in accordance with APB Opinion No. 25, *Accounting For Stock Issued To Employees*, and related interpretations. The Company measures compensation expense for employee and director stock options as the aggregate difference between the market value of its common stock and exercise prices of the options on the date that both the number of shares the grantee is entitled to receive and the exercise prices are known. For pro forma disclosure purposes, the Company values option issuances using the Black-Scholes option pricing model, for the three and six months ended June 30, 2004 and 2003. If the Company had elected to recognize compensation cost for all outstanding options granted by the Company to employees by applying the fair value recognition provisions of SFAS No. 123 *Accounting for Stock Based Compensation*, to employee stock options, net loss and loss per share would have been increased to the pro forma amounts indicated below:

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| | For the Three Months Ended June 30, 2004 | For the Three Months Ended June 30, 2003 | For the Six Months Ended June 30, 2004 | For the Six Months Ended June 30, 2003 |
|---|---|---|---|---|
| Net loss as reported | \$ (1,281,725) | \$ (564,186) | \$ (2,022,816) | \$ (902,476) |
| Total stock-based employee compensation expenses using the fair value based method for all awards, net of related tax effects | (8,542) | (15,789) | (48,205) | (131,614) |
| Net loss, pro forma | \$ (1,290,267) | \$ (579,975) | \$ (2,071,021) | \$ (1,034,090) |
| Basic and diluted net loss per common share: | | | | |
| As reported | \$ (.07) | \$ (.04) | \$ (.12) | \$ (.08) |
| Pro forma | \$ (.07) | \$ (.04) | \$ (.13) | \$ (.09) |
| Black-Scholes option pricing assumptions | | | | |
| Risk-free interest rate | 3%-4.5% | 2.3%-4% | 3.6%-4.5% | 2.3%-4% |
| Volatility | 64%-77% | 64%-128% | 39%-127% | 64%-128% |
| Lives in years | 10 | 3-10 | 10 | 3-10 |
| Dividend yield | 0% | 0% | 0% | 0% |

In addition, options are issued to non-employees such as consultants, scientific advisory board members and directors. Any options issued to non-employees are recorded in the consolidated financial statements as deferred expenses in the stockholders' equity section using the fair value method and then amortized to expense over the applicable service periods.

(D) Loss Per Share

Basic net loss per share is calculated by dividing net loss by the weighted-average number of shares outstanding for each period presented. Diluted net loss per share is the same as basic net loss per share, since potentially dilutive securities from the assumed exercise of stock options and stock warrants would have had an antidilutive effect because the Company incurred a net loss during each period presented. The amount of potentially dilutive securities excluded from the calculation was 2,083,877 at June 30, 2004. There were 2,506,047 potentially dilutive securities at June 30, 2003.

NOTE 2 INVENTORY

The principal components of inventory are as follows:

| | June 30, 2004 (Unaudited) | December 31, 2003 |
|------------------------|--------------------------------------|------------------------------|
| Raw material compounds | \$ 34,987 | \$ 25,796 |
| Work in process | 39,497 | 42,251 |
| Finished goods | 4,324 | 8,845 |

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| | | |
|-----------------|------------------|------------------|
| Total Inventory | <u>\$ 78,808</u> | <u>\$ 76,892</u> |
|-----------------|------------------|------------------|

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NOTE 3 STOCKHOLDERS EQUITY

On February 25, 2004, the Company completed the sale of its securities in a private placement to accredited investors for gross proceeds of approximately \$7.2 million. Investors in the private placement purchased an aggregate of approximately 4.8 million shares of the Company's common stock at a price per share of \$1.50. Additionally, investors received one 5-year warrant to purchase one share of common stock at \$1.65 per share for every two common shares purchased in the offering (a total of 2.4 million warrants). ThinkEquity Partners LLC, Paramount BioCapital, Inc. and Casimir Capital L.P. acted as the placement agents for this offering and received fees of approximately \$500,000 of which Paramount BioCapital, Inc., a related party, received \$300,000. Net proceeds to the Company, after deducting placement agent fees and other expenses relating to the private placement, were approximately \$6.7 million.

The table below illustrates the number of stock options issued to: employees, scientific advisory board members, board of directors and consultants which were issued for services provided:

| | For the Six Months Ended June 30, 2004 |
|--------------------------|---|
| | |
| Balance, January 1, 2004 | 2,841,857 |
| Granted | 205,000 |
| Exercised | 0 |
| Expired | (250) |
| Terminated | (962,730) |
| | 2,083,877 |
| Balance, June 30, 2004 | |

NOTE 4 COMMITMENTS AND CONTINGENCIES

In April 2004, the Company appointed Ronald Brandt to be its President and Chief Executive Officer on an interim basis. In June 2004, the Company appointed Mr. Brandt to serve as President and Chief Executive Officer of its chiral ligand operating subsidiary. In connection with that appointment, Mr. Brandt entered into a new employment agreement with such subsidiary, which superseded his October 2003 employment agreement with the Company. Mr. Brandt's new employment agreement provides for a term expiring in October 2006 and maintains his annual base salary of \$200,000. Mr. Brandt is also entitled to receive bonuses based on the Company's gross revenues, as follows:

(i) A one time payment of \$50,000 upon the completion of the first two consecutive fiscal quarters in which the Company has gross revenue in excess of \$1,000,000;

(ii) A one time payment of \$75,000 upon the completion of the first two consecutive fiscal quarters in which the Company has gross revenue in excess of \$2,500,000;

(iii) For each fiscal quarter in which the Company has gross revenue in excess of \$2,500,000 following the first two consecutive fiscal quarters described in (ii) above, the Company will remit to the Executive a payment of \$10,000.

(iv) A one time payment of \$100,000 upon the completion of the first two consecutive fiscal quarters in which the Company has gross revenue in excess of \$5,000,000; and

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(v) For each fiscal quarter in which the Company has gross revenue in excess of \$5,000,000 following the first two consecutive fiscal quarters described in (iv) above, the Company will remit to the Executive a payment of \$10,000 (in addition to the \$100,000 payment in (iv) above).

Mr. Brandt is also entitled to a \$100,000 bonus upon such time as the Company sells the operating subsidiary for gross proceeds of at least \$40 million.

In the event Mr. Brandt's employment is terminated by the Company upon a change of control (as defined in the employment agreement), or for a reason other than disability or cause (as those terms are defined in the employment agreement), the Company has agreed to pay Mr. Brandt his base salary for 6 months, plus accrued bonuses, provided, that the Company's obligation to continue paying his base salary for a 6-month period will be reduced by the amount Mr. Brandt earns from other employment during that period.

In connection with his employment agreement, Mr. Brandt also received options to purchase an aggregate of 400,000 shares of Company common stock at \$1.01 per share (the fair market value at the date of grant). Of such options, the right to purchase 100,000 shares vests in three equal annual installments beginning June 2004. The right to purchase the remaining 300,000 shares vests as follows: (1) 100,000 shares vest at such time as the closing bid price for the Company's common stock exceeds \$3.00 per share for 10 consecutive trading days during the term of the employment agreement; (2) 100,000 shares vest at such time as the closing bid price for the Company's common stock exceeds \$5.00 per share for 10 consecutive trading days during the term of the employment agreement; and 100,000 shares vest at such time as the closing bid price for the Company's common stock exceeds \$7.00 per share for 10 consecutive trading days during the term of the employment agreement. Mr. Brandt further received an option to purchase 2.5% of the subsidiary's common stock at a price of \$.01 per share, which will vest in 3 annual installments commencing June 2005.

NOTE 5 SUBSEQUENT EVENTS

On August 12, 2004, the Company announced that it changed its name to VioQuest Pharmaceuticals, Inc. and created a new wholly owned subsidiary, VioQuest Drug Development, Inc. which will concentrate on acquiring, developing and commercializing human therapeutics.

The Company also announced that it will assign substantially all of its operating and technology assets relating to its proprietary chemical catalysis platform to a second wholly owned subsidiary which will be renamed Chiral Quest, Inc., and will continue to aggressively pursue its current business plan to commercialize its technology.

NOTE 6 CONTINGENCIES

On August 6, 2004, the Company received a letter from a competitor notifying the Company of the competitor's belief that one of the Company's proprietary ligands was infringing on a European patent held by such competitor. The Company believes that the competitor's claims are without merit. Although the Company does not believe the competitor's claims have any merit, even if the Company were prevented from selling or otherwise marketing the ligand, such prohibition would not have a material adverse effect on the Company's financial condition or results of operations.