# MANAGEMENT'S DISCUSSION & ANALYSIS

## For the Fiscal Year Ended May 31, 2020

# Introduction

This Management Discussion and Analysis (MD&A) explains the material changes in Thermal Energy International Inc.'s ("Thermal Energy" or the "Company") financial position and financial performance for the fiscal year ended May 31, 2020 (or "FY 2020"), and compares the FY 2020 financial results to the previous year ended May 31, 2019 (or "FY 2019"). The consolidated financial statements and accompanying notes constitute an integral part of the discussion and should be read in conjunction with this MD&A. Unless otherwise indicated, all comparisons to the fourth quarter of FY 2020 are against the fourth quarter of FY 2019. Additional information relating to the Company is available on SEDAR at www.sedar.com.

### Currency

All financial information in this report is stated in Canadian Dollars, which is both the presentation and functional currency of the Company. Approximately 36% our operations, assets and liabilities are denominated in British Pound Sterling and 26% in US Dollar. As such, foreign currency fluctuations affect the reported values of individual lines on our statement of financial position and income statement. When the Canadian dollar strengthens, the reported values decrease, and the opposite occurs when the Canadian dollar weakens.

### Review and Approval by the Board of Directors

The Board of Directors, on recommendation of the Audit Committee, approved the content of this MD&A on September 22, 2020. Disclosure contained in this document is current to September 22, 2020, unless otherwise stated.

### Forward-Looking Statements

This MD&A may include statements that are forward-looking. These statements are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. We discuss the principal risks of our business in Section 9 of this MD&A. We cannot provide any assurance that forecasted financial or operational performance will actually be achieved. If it is achieved, we cannot provide assurance that it will result in an increase in our share price. See Section 10 entitled "Forward-Looking Information".

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## 1. Our Business

### 1.1 Company Overview

Thermal Energy, established in 1991, is a global provider of proprietary and proven energy and water efficiency and emission reduction products and solutions to the industrial, commercial, and institutional markets. The Company is headquartered in Ottawa, Canada, with offices in the U.K., Italy, Germany, and U.S.

Thermal Energy engages clients through a unique mix of process, energy, environmental and financial expertise to save our customers money and improve their bottom lines by reducing their fuel use and carbon emissions. The Company's award-winning products have an excellent track record of longevity, proven reliability and performance and have been shown to provide: significant energy savings; improved water efficiency; reduced greenhouse gas emissions; lowered maintenance costs; improved product quality; and increased production efficiency. Thermal Energy's products are effective in a wide range of industries and applications.

More information on Thermal Energy can be found at www.thermalenergy.com. **GEM™, FLU-ACE®, THERMALONOx™** and **DRY-REX™** are trademarks of Thermal Energy.

### 1.2 Core Businesses

The Company operates primarily in North America and Europe but also sells its products and services through representative agents throughout the rest of the world. The Company markets, sells, engineers, fabricates, constructs, installs and supports two technology lines – heat recovery solutions, including direct contact heat recovery solutions (e.g. **FLU-ACE®**), indirect contact heat recovery solutions (**HEATSPONGE** and **SIDEKICK**), and condensate return system solutions (**GEM™** steam traps). The Company is also developing several other technology lines, including low temperature biomass drying systems (**DRY-REX™**).

In 2008, the Company acquired Gardner Energy Management Limited, which owns, manufactures and sells the GEM™ steam traps throughout the world. As part of this transaction, the Company also acquired the 67% share of GEMchem Ltd, a UK-based water treatment company providing services within the UK only. On June 29, 2018, the Company acquired Boilerroom Equipment Inc., a company based in the U.S., which owns, manufactures and sells HEATSPONGE and SIDEKICK indirect contact heat recovery units.

The Company has two primary operational bases of operation, one in Ottawa, Canada covering North America ("Thermal Energy Ottawa"), and the other in Bristol, United Kingdom, covering Europe and the rest of the world ("Thermal Energy Bristol"). Although the Thermal Energy Ottawa is considered to be the center of excellence for heat recovery engineering and technical support, and Thermal Energy Bristol the center of excellence for GEM™ steam traps and condensate return systems engineering and technical support, continuous cross-training means that both Ottawa and Bristol have expertise across both major product lines.

Although the Company markets its products throughout the world, most sales are from within North America and Europe where the Company has direct sales and engineering staff. While North American and European markets continue to be the Company's strategic focus, the Company also continues to look for new agents and distributors in other regions deemed to have potential.

### 1.3 Strategy

The Company's mission is to be a best-in-class provider of return on investment-driven thermal energy efficiency technology and solutions to the industrial, institutional, and commercial sectors, helping our clients around the world improve their bottom line, move towards sustainable operations and reduce their environmental and carbon footprint. The Company's products and services are "best-in-class" with world-wide application in a broad range of sectors.

The Company has representation in 28 countries around the world with a current focus on the key markets of North America and Europe. Thermal Energy's penetration in these markets remains low and therefore the Company plans to continue growing its sales and distribution capabilities in these markets, while at the same time, build its business in other energy-intensive markets around the world.

We have sold our proprietary and proven products to hundreds of companies and institutions, including approximately 50 large companies in the pharmaceutical, food and beverage, pulp and paper, chemical and petrochemical sectors.

With an established global sales and distribution network, the Company is looking to develop and/or acquire additional complementary products and services that can be distributed through its existing network.

## 2. Performance Measures

The Company believes the following performance measures provide useful information to both management and investors to better understand the financial performance and financial position of the Company.

### 2.1 EBITDAS

Management believes that EBITDAS (earnings before interest, taxation, depreciation, amortization, impairment of goodwill and other intangible assets, share-based compensation expense and net write-down of lease) is a useful performance measure as it approximates cash generated from operations, before tax, capital expenditures and changes in working capital, and excludes impairment of goodwill and other intangible assets, and net write-down of lease. EBITDAS also assists comparison among companies as it eliminates the differences in earnings due to how a company is financed. EBITDAS does not have a standardized meaning prescribed by International Financial Reporting Standards ("IFRS") and therefore may not be comparable to similar measures presented by other companies. There is no direct comparable IFRS measure for EBITDAS. A reconciliation of net income (loss) to EBITDAS is shown in section 3.5 Selected Annual Information.

### 2.2 Order Backlog

Order backlog is a useful performance measure that Management uses as an indicator of the short-term future revenue of our Company resulting from already recognized orders. The Company includes in "order backlog" any purchase orders that have been received by the Company but have not yet been reflected as revenue in the Company's published financial statements. It is important to note that once an order or partial order is recorded as revenue, the order backlog is reduced by the amount of the newly reported revenue. Order backlog does not have a standardized meaning prescribed by International Financial Reporting Standards and therefore may not be comparable to similar measures presented by other companies.

## 3. Performance

### 3.1 Summary of Fourth Quarter Results

| | **Q4 2020** | Q4 2019 |
|---|---|---|
| | **$** | $ |
| Revenue | **2,790,664** | 5,974,546 |
| Cost of sales[1] | **(1,362,936)** | (2,857,249) |
| Gross profit | **1,427,728** | 3,117,297 |
| Expenses: | | |
| Administration, selling, marketing and business development [1] | **1,631,126** | 2,280,099 |
| Research and development | **(38,560)** | (60,608) |
| | **1,592,566** | 2,219,491 |
| Other income | **133,826** | - |
| Operating income (loss) before impairment | **(31,012)** | 897,806 |
| Impairment of intangible assets | **(499,718)** | - |
| Impairment of goodwill | **(2,561,482)** | - |
| Operating income (loss) | **(3,092,212)** | 897,806 |
| Finance costs | **(112,767)** | (102,787) |
| Finance revenue | **-** | 3,922 |
| Income (loss) before income taxes | **(3,204,979)** | 798,941 |
| Income taxes recovery (expense) | **251,793** | (198,983) |
| Net income (loss) for the period | **(2,953,186)** | 599,958 |
| Exchange differences on translation of overseas operations | **(50,695)** | (45,100) |
| Total comprehensive income (loss) for the period | **(3,003,881)** | 554,858 |
| EBITDAS for the quarter[2] | **31,412** | 1,029,103 |
| Order backlog as at May 31 | **3.6 million** | 14.0 million |
| Order backlog as at reporting date | **9.3 million** | 18.2 million |

1. The Company reclassified commission expense from selling, marketing and business development expense to cost of sales effective June 1, 2019. As a result, commission expense in the amount of $356,079 for the comparative period was reclassified from selling, marketing and business development expense to cost of sales.
2. A reconciliation of net income (loss) to EBITDAS is shown in section 3.5 Selected Annual Information.

***Revenues and Gross Profits***

Revenues were $2,790,664 in the quarter ended May 31, 2020, representing a decrease of $3,183,882, or -53.3%, compared to $5,974,546 in the quarter ended May 31, 2019. The decrease of revenue in the fourth quarter of FY 2020 was mainly due to the delay in the delivery of heat recovery systems. The COVID-19 pandemic caused significant delays on heat recovery projects because customers' sites were either closed or our technical team and the subcontractors could not travel to site due to the travel restrictions. The revenues of condensate return systems also decreased in the fourth of FY 2020 compared to the same quarter last year. The Company received less orders in the condensate return systems in the fourth quarter due to the COVID-19 pandemic.

The gross profit of $1,427,728 in the quarter ended May 31, 2020 represented a decrease of $1,689,569, or -54.2%, from the $3,117,297 in the quarter ended May 31, 2019 due to the decrease in the sales of heat recovery systems and condensate return systems. Gross profit expressed as a percentage of sales was 51.2% in the fourth quarter of FY 2020 compared with 52.2% in the same quarter of FY 2019.

***Expenses***

***Administration, selling, marketing and business development expenses ("Operating Expenses")*** in the quarter ended May 31, 2020 totaled $1,631,126 compared to $2,280,099 in the quarter ended May 31, 2019, a decrease of $648,973, or 28.5%. During the fourth quarter of FY 2020, the company received COVID-19 related wage subsidies from various government bodies in the amount of $258,543. Since March 2020, the Company's business activities significantly slowed down due to the travel restrictions and temporary lock-down caused by COVID-19. To reduce the costs, the Company implemented new cost control measures including postponement of discretionary expenditures. The slow-down in the business activities also resulted in the reduced operating costs, including general administration cost, marketing, selling and business development cost. As a result, the operating expenses decreased significantly in the fourth quarter of FY 2020.

***Research and development ("R&D")*** related to expenditures on various research and development programs. The Company receives tax credits and government funding on various research programs related to product development. The tax credits and government funding are accounted as a reduction of research and development expenses. The Company recorded the estimated R&D tax credits related to FY 2020 in the fourth quarter of F2020. Hence, the Company recognized a R&D expense recovery of $38,560 in the fourth quarter of FY 2020.

***Other income*** in the amount of $133,826 was related to the write-down of the contingent earn-out, which was first recognized as a contingent liability at the time of acquisition of Boilerroom Equipment Inc. The contingent earn-out is payable if certain performance targets are met over the 36 months after the acquisition. As the performance targets are likely not being met, the entire amount was written down.

***Impairment of intangible assets and goodwill:*** The Company recognized impairment charge of $3,061,200 on intangible assets and goodwill in the fourth quarter of FY 2020. The impairment is caused by the decline in the internal forecasts of revenues for the next 24 months due partly to economic uncertainty arising from the COVID-19 pandemic.

***Finance costs and finance revenue:*** Finance costs include interest expense on the long-term debt, interest accretion on contingent payable and holdback payable related to acquisition, and amortization on financing cost. The fourth quarter of FY 2020 incurred a finance cost of $112,767. The cost was higher than the fourth quarter of FY 2019 by $9,980 because the interest rate on the long-term debt was higher for FY 2020 than FY 2019. The interest rate is reassessed annually.

***Loss before income taxes*** for the quarter ended May 31, 2020 was $3,204,979, compared to an income of $798,941 in the same quarter of the previous year. Income before income taxes decreased by $4,003,920 mainly due to the impairment charge of $3,061,200 on intangible assets and goodwill, the decrease of gross profit of $1,689,569 offset by the decrease in the operating expenses of $648,973.

***Income tax recovery*** in the fourth quarter of FY 2020 was $251,793, as compared to an expense of $198,983 in the fourth quarter of FY 2019, an increase of $450,776. In FY 2019, the Company's subsidiary based in the UK incurred operational losses. Tax losses can be carried forward and used against future income, which gave rise to income tax recovery of $252,231 relating to the UK subsidiary for the first three quarters of FY 2019. In the fourth quarter of FY 2019, after having a loss for eight consecutive quarters, the Company applied a valuation allowance to the UK subsidiary's deferred tax asset to decrease the income tax recovery recognized from the first three quarters of FY 2019, which resulted in the income tax expense of $198,983 for the fourth quarter of FY 2019. In the fourth quarter of FY 2020, income tax recovery of $251,793 was recognized. $103,230 of the recovery was related to the write-down of deferred tax liabilities because of the impairment write-down on intangible assets of $499,718. When the intangible assets were first recognized at the date of acquisition, deferred tax liabilities on these assets were also recognized. When these intangible assets were written down through impairment, the deferred taxes associated with these assets were also discharged. $197,322 of the tax recovery was recognized by the Company's US subsidiary which incurred a taxable loss in F2020. The US tax authority had provided a tax relief measure under COVID-19, under which a business was permitted to carry back taxable loss to apply against taxable income from previous tax years. As a result, the Company expected to receive tax refund of $197,322 by applying for this tax relief measure.

***Net loss for the fourth quarter*** of FY 2020 was $2,953,186, compared to a net income of $599,958 in the same quarter of the previous year, representing a decrease of $3,553,144. The decrease in net income was mainly due to the impairment charge of $3,061,200 on intangible assets and goodwill, the decrease of gross profit of $1,689,569 offset by the decrease in the operating expenses of $648,973 and the increase in income tax recovery of $450,776.

***Comprehensive loss*** was $3,003,881 for the fourth quarter of FY 2020, compared to a comprehensive income of $554,858 for the fourth quarter of FY 2019. The increased comprehensive loss was due to the increase in the net loss of $3,553,144.

***EBITDAS*** was $31,412 for the fourth quarter of FY 2020, compared to a $1,029,103 for the same quarter of the previous year, representing a decrease of $997,691. The decrease was mainly due to the decrease in gross profit of $1,689,569 offset by the reduction of operating expenses of $648,973.

### 3.2 Review of Year End Results

| | 2020 | 2019 |
|---|---|---|
| | **$** | $ |
| Revenue | **21,416,175** | 21,083,256 |
| Cost of sales[1] | **(12,462,122)** | (13,042,050) |
| Gross profit | **8,954,053** | 8,041,206 |
| Expenses: | | |
| Administration, selling, marketing and business development expenses | **7,848,011** | 8,247,328 |
| Research and development | **(35,840)** | 71,703 |
| | **7,812,171** | 8,319,031 |
| Other income | **133,826** | - |
| Operating income (loss) before impairment | **1,275,708** | (277,825) |
| Impairment of intangible assets | **(499,718)** | - |
| Impairment of goodwill | **(2,561,482)** | - |
| Operating loss | **(1,785,492)** | (277,825) |
| Finance costs | **(420,220)** | (302,394) |
| Finance revenue | **5,144** | 20,413 |
| Loss before income taxes | **(2,200,568)** | (559,806) |
| Income taxes recovery | **303,611** | 108,703 |
| Net loss for the year | **(1,896,957)** | (451,103) |
| Exchange differences on translation of overseas operations | **(50,973)** | (8,423) |
| Total comprehensive loss for the year | **(1,947,930)** | (459,526) |
| | | |
| EBITDAS[2] | **1,921,495** | 176,006 |
| Order backlog as at May 31, 2020 | **3.6 million** | 14.0 million |
| Order backlog as at September reporting date | **9.3 million** | 18.2 million |

1. The Company reclassified commission expense from selling, marketing and business development expense to cost of sales effective June 1, 2019. As a result, commission expense in the amount of $1,192,170 for the comparative period was reclassified from selling, marketing and business development expense to cost of sales.
2. A reconciliation of net income (loss) to EBITDAS is shown in section 3.5 Selected Annual Information.

#### *Revenues and Gross Profits*

Revenues were $21,416,175 in the year ended May 31, 2020, representing an increase of $332,919, or 1.6%, over the $21,083,256 recognized in the year ended May 31, 2019. The increase in revenues was due to the increased sales in the European and the Rest of the World market for both heat recovery solutions and the condensate return systems.

The gross profit of $8,954,053 in the year ended May 31, 2020 represented an increase of $912,847, or 11.4%, from the $8,041,206 achieved in the year ended May 31, 2019. The increase was mainly due to increased margins on the heat recovery projects as the revenues are comparable to prior year. In FY 2019, the Company completed a mega heat recovery project with the total contract value of $11 million. The gross margin on this mega project was lower than average margin because the Company provided a discounted price to the customer in order to win this mega project. In FY 2020, there was no mega project. As a result, the overall gross margin on the heat recovery projects improved in FY 2020. The gross profit expressed as a percentage of sales also increased from 38.1% in FY 2019 to 41.8% in FY 2020.

***Expenses***

***Administration, selling, marketing and business development expenses ("Operating Expenses")*** in the year ended May 31, 2020 totaled $7,848,011 compared to $8,247,328 in FY 2019, representing a decrease of $399,317, or 4.8%. The decrease was mainly due to the increase of foreign exchange gain of $103,417, the decrease in the acquisition related cost of $114,876, the receipt of government wage subsidies of $258,543, offset by the increase in the share based compensation expense of $88,447. The Operating Expenses as a percent of revenue was 36.6% in FY 2020 compared to 39.1% in FY 2019.

***Research and development*** related to expenditures on various research and development programs. The Company receives tax credits and government funding on various research programs related to product development. The tax credits and government funding are accounted as a reduction of research and development expenses. The Company's R&D expense was negative $35,840 in FY 2020, compared to an expense $71,703 in FY 2019, a decrease of $107,543 in R&D expense. The decrease was mainly due to the increased amount of R&D tax credits and government funding applied. During the year ended May 31, 2020, the Company applied for R&D tax credits and government funding in the amount of $181,498. In FY 2019, the Company only claimed $50,000 related to R&D tax credits and government funding.

***Finance costs and finance revenue***: In the year ended May 31, 2020, finance costs increased by $117,826 from $302,394 to $420,220. The increase was mainly due to the increased interest rate on the long-term debt.

***Loss before income taxes*** for the year ended May 31, 2020 was $2,200,568 compared to a loss of $559,806 in the same period of the previous year, representing an increase of $1,640,762. The increase was mainly due to impairment charge of $3,061,200 recorded on intangible assets and goodwill, offset by the increase in gross profits of $912,847, the decrease in operating expenses of $399,317, the decrease in research and development expense of $107,543, and the other income of $133,826 recognized for the year.

***Income tax recovery*** in FY 2020 was $303,611, compared to $108,703 in FY 2019, an increase of $194,908. Both the U.K. and the U.S. entities are subject to tax charges. Fluctuations in the tax charges are the result of changing profitability in those entities. In FY 2020, income tax recovery of $197,322 was recorded by the Company's US subsidiary as the subsidiary incurred taxable losses in FY 2020. The income tax recovery for FY 2020 also included the write-down of deferred tax liabilities of $103,230 that were associated with certain intangible assets, which were written down through impairment charge in the fourth quarter of FY 2020.

***Net loss*** for the year ended May 31, 2020 was $1,896,957, compared to a loss of $451,103 in the year ended May 31, 2019, representing an increase of $1,445,854. The increase was mainly due to the impairment charge of $3,061,200 recognized on intangible assets and goodwill offset by the increase in operating income before impairment of $1,553,533.

***Comprehensive loss*** was $1,947,930 for the year ended May 31, 2020, compared to a loss of $459,526 for the year ended May 31, 2019.

***EBITDAS*** was $1,921,495 for the year ended May 31, 2020 compared to $176,006 for the previous year, representing an increase of $1,745,489. The increase was mainly due to the increase in gross profits of $912,847, the decrease in operating expenses of $399,317, the decrease in research and development expense of $107,543, and the other income of $133,826 recognized for the year.

### 3.3 Liquidity & Capital Resources

Current assets increased by $79,184 to $8,063,550 at May 31, 2020, compared to $7,984,367 at May 31, 2019. This increase was mainly due to the increase in cash and cash equivalents of $597,320, the increase in current tax receivable of $190,207 and the increase in inventory of $190,741 offset by the reduction in accounts receivable of $805,828 and finance lease receivable of $93,257. Current liabilities decreased by $764,530 to $5,192,014, mainly due to the decrease in deferred revenue of $1,667,362 and the decrease in the current portion of long-term debt of $102,107, offset by the increase in trade payable and accrued liabilities of $888,357 and the increase in short-term lease obligations of $105,269.

Working capital increased by $843,713 to $ 2,871,536 at May 31, 2020, compared to $2,027,823 at May 31, 2019. The increase was mainly due to the significant decrease in deferred revenue of $1,667,362 at May 31, 2020, the increase in cash and cash equivalents of $597,320, offset by the increase of trade payable and other liabilities of $888,357 and the decrease in trade and other receivables of $805,828. Deferred revenue is recorded when the Company receives cash deposit before it delivers products or services to a customer. Deferred revenue decreases when the Company delivers the work to the customer and revenue is recognized. As at May 31, 2020, a few heat recovery projects were completed or close to be completed which resulted in the decrease in deferred revenue. When a project is close to the completion, the Company will receive the billings from subcontractors and vendors for the equipment and installation cost, hence, the Company will have a higher amount in the trade payable at the completion or close to completion stage of a heat recovery project.

The Company's working capital position over the last eight quarters can be summarized as follows:

| | Aug 31, 2018 $ | Nov 30, 2018 $ | Feb 28, 2019 $ | May 31, 2019 $ | Aug 31, 2019 $ | Nov 30, 2019 $ | Feb 29, 2020 $ | May 31, 2020 $ |
|---|---|---|---|---|---|---|---|---|
| Current Assets | 8,310,609 | 7,244,731 | 7,337,334 | 7,984,367 | 9,544,737 | 9,574,004 | 8,646,798 | 8,063,550 |
| Current Liabilities | 5,984,275 | 5,178,449 | 8,816,994 | 5,956,544 | 7,423,040 | 7,129,049 | 5,859,669 | 5,192,014 |
| Working Capital | 2,326,334 | 2,066,282 | (1,479,660) | 2,027,823 | 2,121,697 | 2,444,955 | 2,787,129 | 2,871,536 |

The Company's cash position was $4,774,580 as at May 31, 2020, compared to $4,177,260 at May 31, 2019, representing an increase of $597,320. The increase was mainly due to net cash generated from operating activities of $1,309,613 as well as foreign exchange gain impact of $ 19,341 offset by the cash used in investing activities $280,548 and the financing activities of $451,086.

The net cash generated from the operating activities included the net loss of $1,896,957 and the addbacks of non-cash items of $3,787,918, offset by the negative change in working capital of $242,853, the interest paid on long-term debt of $326,695 and the income taxes paid of $11,800. The Company's cash position normally fluctuates based on the timing of long-term projects. Cash increases at the beginning of a project because the Company receives upfront deposit before a project is started. The cash position decreases when a project is near the end because the Company has collected from its customer and needs to make full payments to the suppliers and subcontractors. A few heat recovery projects were completed or close to the completion as at May 31, 2020, therefore there was a negative change in working capital of $242,853.

The Company invested $280,548 in property, plant and equipment during the year ended May 31, 2020, of which $169,116 related to a leasehold improvement and $35,129 related to furniture and fixtures for a new rental space. The Company also purchased production equipment of $43,327 and computers of $32,976 during the year. The Company made the investment to purchase more laptop computers early in the year so that the technical team could travel easily with a laptop.

The Company's used cash for financing activities, which included repayments to the long-term debt of $297,179, repayments related to the lease obligations of $99,832, the purchase of Class A common shares of $127,317 under the Normal Course Issuer Bid and the dividends paid to a non-controlling interest party of $16,758. The Company received $90,000 lease incentive payment from the landlord for the new rental space.

The Company's trade and other receivables have been reviewed for indicators of impairment. May 31, 2020, $189,442 (10%) of the Company's trade receivables balance was over 90 days past due. $61,120 of the past due balance was impaired at May 31, 2020. $6,318 of trade receivables that was not over 90 days past due was also impaired.

At May 31, 2019, $123,223 (6.2%) of the Company's trade receivables balance was over 90 days past due. $22,864 of the past due balance was impaired at May 31, 2019.

The Company's finance lease receivable includes the following:

| | **2020** | 2019 |
|---|---|---|
| Total estimated minimum lease payments receivable | **$ 47,500** | $ 100,053 |
| Less: unearned income | **(1,652)** | (6,796) |
| Less: write-down | **(45,848)** | - |
| | **-** | 93,257 |
| Less: current portion | **-** | (93,257) |
| | **-** | - |

Finance lease receivable relates to one arrangement. The estimated minimum lease payments receivable in this lease represent the estimated monthly energy outputs of the leased asset and are based on assumptions regarding the efficiency of the asset, the operations of the plant in which it is located and penalty payments resulting from temporary plant shut-downs.

On December 16, 2019, Fortress Specialty Cellulose sought and obtained a First Day Initial Order under the Companies' Creditors Arrangement Act from the Quebec Superior Court. The Company's finance lease receivable was reviewed for indicators of impairment. For the year ended May 31, 2020, a write-down of $45,848 was recognized on the remaining finance lease receivable under administrative expenses. Trade receivables from the customer amounting to $106,241 (net of $15,910 sales tax) were provided for and written off as expected credit loss under administration expenses.

The following table presents the contractual undiscounted cash flows for lease obligations as of May 31, 2020:

| | |
|---|---|
| Less than one year | $ 141,157 |
| One to five years | 293,827 |
| Six to ten years | 286,500 |
| Total undiscounted lease obligations | $ 721,484 |

The Company's ability to realize its assets and discharge its liabilities depends on its ability to generate sufficient cash from operations or its ability to arrange debt or equity financing.

On June 9, 2020, the Company entered into a Working Capital – COVID-19 loan with a lending institution for a total amount of $2,300,000. The amounts advanced under the financing will be expected to support internal working capital needs related to operations and to assist with a degree of continuity of operations of the Company during the current economic environment. This loan bears interest at the institution's floating base rate less a variance of 1.10% and is repayable over the next 3 years. The institution's floating base rate was at 4.55% on June 9, 2020. The first tranche of the proceeds in the amount of $1,000,000 was received by the Company on July 23, 2020. The remaining amount of $1,300,000 is expected to be received in two separate tranches by March 2021.

Management is of the opinion that there is sufficient cash to support the Company's operations for the next 12 months. Once the COVID-19 pandemic ends, the Company will be generating sufficient cash by achieving profitable operations through continuing to manage expenditures, concentrating on building upon revenue levels experienced from FY 2016 to FY 2020.

### 3.4 Segmentation Information

In fiscal 2020 and 2019, the Company operated in the energy efficiency industry in North America, Europe, China and Rest of the World. The Company markets, sells, engineers, fabricates, constructs, installs and supports two technology lines - heat recovery solutions and condensate return system solutions. The Company is also developing a third technology line - low temperature biomass drying systems. Assets are located in Canada and Europe.

Management reporting comprises analysis of revenue and gross profit within two distinct geographical areas. All other items of revenue and expenses are considered on a geographical and/or global basis in making strategic decisions regarding the Company's future. The Company has two operational bases ("reporting units"), one in Ottawa, Canada covering North America and China, and the other in Bristol, UK, covering Europe and the rest of the world. These areas are determined by proximity of the region to the reporting unit, plus the location of the contracts in existence with agents and distributors in the respective areas and the historical relationships with those agents and distributors. Corporate costs that cannot easily be attributed to either of the two reporting units are included in reconciling items. The chief operating decision maker focuses on revenues and costs by geographical segments, but manages assets and liabilities on a global basis.

Segment information for the year ended May 31, 2020 and the comparative year are detailed in the table below:

| | Thermal Energy Ottawa | | Thermal Energy Bristol | | Reconciling Items | | Total | |
|---|---|---|---|---|---|---|---|---|
| | **2020** | 2019 | **2020** | 2019 | **2020** | 2019 | **2020** | 2019 |
| | **$** | $ | **$** | $ | **$** | $ | **$** | $ |
| Total revenue from external customers | **13,337,357** | 16,648,483 | **8,078,818** | 4,434,773 | **-** | - | **21,416,175** | 21,083,256 |
| Cost of sales [1] | **(8,452,200)** | (10,806,725) | **(4,009,922)** | (2,235,325) | **-** | - | **(12,462,122)** | (13,042,050) |
| Gross profit | **4,885,157** | 5,841,758 | **4,068,896** | 2,199,448 | **-** | - | **8,954,053** | 8,041,206 |
| Other expenses [1] | **(3,215,008)** | (3,585,362) | **(3,266,531)** | (3,284,294) | **(1,330,632)** | (1,449,375) | **(7,812,171)** | (8,319,031) |
| Other income | **133,826** | - | **-** | - | **-** | - | **133,826** | - |
| Impairment of intangible assets | **(103,548)** | - | **(396,170)** | - | **-** | - | **(499,718)** | - |
| Impairment of goodwill | **(1,360,450)** | - | **(1,201,032)** | - | **-** | - | **(2,561,482)** | - |
| Net finance income (costs) | **(19,319)** | 20,413 | **(14,179)** | - | **(381,578)** | (302,394) | **(415,076)** | (281,981) |
| Income (loss) before taxation | **320,658** | 2,276,809 | **(809,016)** | (1,084,846) | **(1,712,210)** | (1,751,769) | **(2,200,568)** | (559,806) |
| Tax recovery (expense) | **208,132** | 52,969 | **(8,236)** | (113,030) | **103,715** | 168,764 | **303,611** | 108,703 |
| Profit (loss) after taxation | **528,790** | 2,329,778 | **(817,252)** | (1,197,876) | **(1,608,495)** | (1,583,005) | **(1,896,957)** | (451,103) |
| Attributable to: | | | | | | | | |
| Owners of the parent | **548,847** | 2,378,592 | **(838,795)** | (1,219,873) | **(1,608,495)** | (1,583,005) | **(1,898,443)** | (424,286) |
| Non-controlling interest | **(20,057)** | (48,814) | **21,543** | 21,997 | **-** | - | **1,486** | (26,817) |

(1) The Company reclassified commission expenses from other expenses to cost of sales for the year ended May 31, 2020. As a result, commission expenses in the amount of $1,192,170 for the year ended May 31, 2019 were also reclassified to cost of sales to conform to the current period presentation.

Reconciling items comprise the following:

| | **2020** | 2019 |
|---|---|---|
| Corporate administration costs | **$ 633,600** | $ 696,564 |
| Share-based compensation | **203,793** | 115,346 |
| Professional fees | **180,109** | 138,092 |
| Depreciation of property, plant and equipment | **110,422** | 84,509 |
| Amortization of intangible assets | **280,580** | 253,976 |
| Acquisition costs | **33,973** | 148,849 |
| Bank charges and interest | **-** | 20,467 |
| Foreign exchange differences | **(111,845)** | (8,428) |
| Total | **1,330,632** | $ 1,449,375 |

Corporate administration costs include directors' fees, all costs relating to both the CEO and CFO, directors' and officers' insurance, corporate legal costs, public relations costs, professional fees relating to group tax planning and corporate filing costs as well as the Annual General Meeting.

Finance costs within the reconciling items include interest and deferred financing charge on the long-term debt and interest accretion on contingent consideration and holdback payable following the acquisition of Boilerroom Equipment Inc.

### *Material Segmentation Variances*

#### Thermal Energy Ottawa:

Revenue for the year ended May 31, 2020 of $13,337,357, represented a decrease of $3,311,126, or 19.9%, over the $16,648,483 in the previous year. The decrease was mainly due to the reduced sales in both heat recovery systems and condensate return systems.

Gross profit for the year ended May 31, 2020 decreased by $956,601 over the last year. The decrease in gross profit was mainly due to the decreased sales. As a percentage of revenue, gross profit was 36.6% for the year ended May 31, 2020, compared to 35.1% achieved in last year.

Other expenses in this segment decreased by $370,354 (10.3%) for the year ended May 31, 2020 over the last year. The decrease was mainly due to the decrease in operating costs due to the reduced amount of business activities and the $197,895 government wage subsidies received.

For the year ended May 31, 2020, income before tax of $320,658 was achieved, represented a decrease of $1,956,151, or 85.9%, from the previous year. The decrease was mainly due to the impairment charge of $1,463,998 recognized on intangible assets and goodwill related to Boilerroom Equipment Inc. and the decrease of gross profit of $956,601 because of the decreased revenues, offset by the decrease in other operating expenses of $370,354 and the other income of $133,826 related to the write-off of contingent earn-out for Boilerroom Equipment Inc.

#### Thermal Energy Bristol:

Revenue for the year ended May 31, 2020 of $8,078,818, represented an increase of $3,644,045, or 82.2%, over the $4,434,773 achieved in the previous year. The increase for the year ended May 31, 2020 was due to increased sales in both condensate return systems and heat recovery systems.

Gross profit increased in the year ended of FY 2020 by $1,869,448, compared to the last year. The increase in gross profit was mainly due to the increased sales in both heat recovery systems and condensate return systems. As a percentage of revenue, gross profit was 50.4% in the FY 2020, compared to 49.6% achieved in the FY 2019.

Other expenses decreased by $17,763 or 0.5% for the year ended May 31, 2020, compared to prior year. This segment received the government wage subsidies of $60,648 during the fourth quarter of FY 2020.

The resulting pre-tax loss was $809,016 for the year ended May 31, 2020, as compared to a loss of $1,084,846 for the prior year, a decrease of $275,830. The improved pre-tax loss was mainly due to the increase of $1,869,448 in gross profit offset by the impairment charge of $396,170 on trade names and trademarks and the impairment charge of $1,201,032 on goodwill related to the Company's UK subsidiaries' cash-generating units.

### Reconciling Items:

Other expenses within Reconciling items, which incorporates all costs not specifically attributable to either regional operational center, decreased by $118,743 to $1,330,632, compared to the previous year. The decrease in other expenses was mainly due to the increase of the foreign exchange gains of $103,417, the reduction of corporate admin cost of $62,964, the decrease of acquisition cost of $114,876, offset by the increase in professional fees of $42,017 and share-based compensation expense of $88,447.

### 3.5 Selected Annual information

The following table shows selected consolidated financial data for the three most recently completed financial years.

Financial information for the years ending May 31, 2018, 2019 and 2020:

| | 2018<br>$ | 2019<br>$ | 2020<br>$ |
|---|---|---|---|
| Revenue | 17,408,211 | 21,083,256 | 21,416,175 |
| Gross Profit(1) | 6,929,523 | 8,041,206 | 8,954,053 |
| Gross Profit Percentage | 39.8% | 38.1% | 41.8% |
| EBITDAS(2) | 616,905 | 176,006 | 1,921,495 |
| Total net income (loss) attributable to owners of the parent | 638,998 | (424,286) | (1,898,443) |
| Net profit (loss) per share – basic and diluted | 0.004 | (0.003) | (0.012) |

(1) The Company reclassified commission expense from selling, marketing and business development expense to cost of sales effective June 1, 2019. As a result, commission expense in the amount of $1,192,170 and $1,404,500 for 2019 and 2018, respectively, was reclassified from selling, marketing and business development expense to cost of sales, which resulted in decreased gross profit for these two comparative years.

(2) EBITDAS represents earnings before interest, taxation, depreciation, amortization, impairment of goodwill and other intangible assets, share-based compensation expense and net write down of lease.

A reconciliation of net income (loss) to EBITDAS is shown below:

| | 2018<br>$ | 2019<br>$ | 2020<br>$ |
|---|---|---|---|
| Total net income (loss) attributable to owners of the parent | 638,998 | (424,286) | (1,898,443) |
| Total net income (loss) attributable to non-controlling interest | (19,519) | (26,817) | 1,486 |
| Interest charge | 2,302 | 302,394 | 420,220 |
| Interest received | (349) | (20,413) | - |
| Taxation | (98,475) | (108,703) | (303,611) |
| Depreciation and amortization | 44,342 | 338,485 | 391,002 |
| Share based compensation | 49,606 | 115,346 | 203,793 |
| Impairment – intangible assets | - | - | 499,718 |
| Impairment - goodwill | - | - | 2,561,482 |
| Net write-down of lease | - | - | 45,848 |
| EBITDAS | 616,905 | 176,006 | 1,921,495 |

For the eight quarters ended May 31, 2020:

| Quarter ended | 31-Aug-19<br>$ | 30-Nov-19<br>$ | 29-Feb-20<br>$ | 31-May-20<br>$ |
|---|---|---|---|---|
| Revenue | 4,965,789 | 7,848,096 | 5,811,626 | 2,790,664 |
| Gross Profit(1) | 2,190,518 | 2,918,357 | 2,417,450 | 1,427,728 |
| Gross Profit Percentage | 44.1% | 37.2% | 41.6% | 51.2% |
| EBITDAS(2) | 471,786 | 709,182 | 709,115 | 31,412 |
| Total net income (loss) | 241,261 | 385,181 | 429,787 | (2,953,186) |
| Income (loss) per share, basic and diluted | 0.002 | 0.002 | 0.003 | (0.019) |

| Quarter ended | 31-Aug-18<br>$ | 30-Nov-18<br>$ | 28-Feb-19<br>$ | 31-May-19<br>$ |
|---|---|---|---|---|
| Revenue | 6,800,861 | 5,193,092 | 3,114,757 | 5,974,546 |
| Gross Profit(1) | 1,946,035 | 1,834,770 | 1,143,104 | 3,117,297 |
| Gross Profit Percentage | 28.6% | 35.3% | 36.7% | 52.2% |
| EBITDAS(2) | (50,736) | (67,995) | (734,366) | 1,029,103 |
| Total net income (loss) | (49,458) | (112,122) | (889,481) | 599,958 |
| Income (loss) per share, basic and diluted | 0.00 | (0.001) | (0.006) | 0.004 |

(1) The Company reclassified commission expense from selling, marketing and business development expense to cost of sales effective June 1, 2019. As a result, commission expense for the quarters ended before May 31, 2019 was reclassified from selling, marketing and business development expense to cost of sales to conform to the current year presentation.

(2) EBITDAS represents earnings before interest, taxation, depreciation, amortization, impairment of goodwill and other intangible assets, share-based compensation expense and net write-down of lease.

## 4. Related Party Transactions

Options outstanding for Directors (excluding the CEO) as at May 31, 2020 were 1,000,000, of which 500,000 were exercisable. There were no warrants outstanding for Directors.

Options outstanding for Senior Management (including the CEO) as at May 31, 2020 were 5,758,360, of which 2,800,027 were exercisable. There were no warrants outstanding for Senior Management.

### *Directors and Senior Management Compensation*

During the year ended May 31, 2020 compensation arrangements for directors was as follows:

$13,500 per annum per Director plus an additional $8,100 per annum payable to the Chairman of the Board, $5,400 per annum payable to the chairperson of the Audit Committee, $5,400 per annum payable to the chairperson of the Ethics Committee, and $1,000 payable for each in-person meeting.

During the year ended May 31, 2020, Directors fees paid were $74,881. Fees to the Chairperson of the Audit Committee were $5,400; fees to the Chairperson of the Ethics, Governance and Compliance Committee were $5,400; fees paid to the Chairman were $8,100. Two in-person meetings were held during the year, a total cost of $10,000.

Compensation paid to directors and officers during the year ended May 31, 2020 (inclusive of the amounts described above but excluding share-based compensation) was as follows:

| | Salaries and fees | | Incentives | | Other short-term benefits | | Total | |
|---|---|---|---|---|---|---|---|---|
| | **2020** | 2019 | **2020** | 2019 | **2020** | 2019 | **2020** | 2019 |
| | **$** | $ | **$** | $ | **$** | $ | **$** | $ |
| **Directors** | | | | | | | | |
| M. Williams | **16,247** | 18,500 | **-** | - | **-** | - | **16,247** | 18,500 |
| J. Kelly | **25,195** | 26,600 | **-** | - | **-** | - | **25,195** | 26,600 |
| W. Ollerhead | **22,546** | 22,900 | **-** | - | **-** | - | **22,546** | 22,900 |
| D. Spagnolo | **22,546** | 20,245 | **-** | - | **-** | - | **22,546** | 20,245 |
| W. White | **17,247** | 18,500 | **-** | - | **-** | - | **17,247** | 18,500 |
| J. Schoenmakers(3) | **-** | 10,293 | **-** | - | **-** | - | **-** | 10,293 |
| Total | **103,781** | 117,038 | **-** | - | **-** | - | **103,781** | 117,038 |
| | | | | | | | | |
| **Senior Management** | | | | | | | | |
| W. Crossland | **235,500** | 240,000 | **34,883** | - | **4,097** | 3,953 | **274,480** | 243,953 |
| R. Triebe | **177,606** | 181,000 | **26,307** | - | **7,619** | 7,333 | **211,532** | 188,333 |
| S. Mawby(1) | **150,342** | 157,961 | **20,243** | - | **24,534** | 24,726 | **195,119** | 182,687 |
| J. Zhang(2) | **122,656** | 104,167 | **20,242** | - | **7,347** | 9,442 | **150,245** | 113,609 |
| J. Flynn(2) (4) | **-** | 35,429 | **-** | | **-** | 5,619 | - | 41,048 |
| Total | **686,104** | 718,557 | **101,675** | - | **43,597** | 51,073 | **831,376** | 769,630 |
| Total Related Party Transactions | **789,885** | 835,595 | **101,675** | - | **43,597** | 51,073 | **935,157** | 886,668 |

Other short-term benefits include cash payments for social security costs, employee benefits, and payments made into defined contribution pension plans of the Company's U.K. based subsidiaries.

(1) Mr. Mawby is compensated in UK Pound sterling. Average exchange rate to Canadian dollar was 1.6895 and 1.7184 in FY 2020 and FY 2019, respectively.
(2) Ms. Flynn stepped down as Chief Financial Officer effective July 31, 2018 and Ms. Zhang was appointed Chief Financial Officer of the Corporation effective the same date.
(3) Mr. Schoenmakers resigned on November 27, 2018.
(4) Ms. Flynn was compensated in UK Pound sterling. Average exchange rate to Canadian dollar was 1.7184 in FY 2019.

## 5. COVID-19 Update

On March 11, 2020, COVID-19 was declared a global pandemic by the World Health Organization. The Company has been closely monitoring the impact of COVID-19 on all aspects of its business. COVID-19 has had disruptive effects in countries in which the Company operates including Canada, US and the UK.

We are conducting business with substantial modifications to employee travel and employee work locations. The travel restrictions have decreased business development and sales activities. While most of our customers are essential businesses and continue to operate, the pandemic also has impacts on many of them, including adapting their operation to include physical distancing, limiting site visits, delays in making purchasing decisions and the temporary suspension of on-going projects.

The Company has taken proactive measures to cope with the impact from COVID-19 including the deployment of video conferencing tools, the development of remote working and file-sharing capabilities, a temporary reduction in non-essential expenditures, and the application of government sponsored emergency loans and salary subsidy programs. Despite the COVID-19 slowdown, the Company has maintained its pre-pandemic staff levels and has maintained its full production and project development capabilities. After three years of strong revenue growth and staff additions, the Company is using this time to conduct extensive staff training and product and project development. In short, we are taking advantage of the current slowdown to adapt and strengthen our business and to ensure the Company emerges from the COVID period in as strong a position as possible.

Currently, we are unable to estimate the long-term impact of COVID-19 on our businesses, financial position, results of operations, and cash flows. We expect COVID-19 to continue to affect our results of operations in the next 12 months because of the decline in forecasted revenues.

The Company is working towards a full recovery by continuing developing new sales opportunities through remote work with customers using various technology tools. The Company has received $5.7 million new orders since May 31, 2020. See section 6 Business Outlook below for a review of orders received and order backlog information. We also have sufficient liquidity available from cash to support the business' operations. As at May 31, 2020, the cash balance was $4,774,580. In addition, the Company entered a Working Capital COVID-19 loan in the amount of $2.3 million on June 9, 2020 with a lending institution. We received the first tranche of the proceeds in the amount of $1,000,000 on July 23, 2020. See section 3.3 Liquidity and Capital Resources for more details about this loan.

## 6. Business Outlook

Governments around the world are taking unprecedented action, including increasing regulations, to reduce carbon emissions. Energy efficiency can make the transition toward a clean energy economy faster and cheaper than other initiatives, and therefore is an important element in energy policies around the world. As such, the industrial sector has begun to feel the pressing need to adopt measures that can improve the energy efficiency of internal processes and operations, thus contributing to an increased demand for energy efficiency products, solutions and services globally.

Other than our order backlog, we do not provide specific financial performance guidance. However, we believe that we are well positioned to benefit from this increased demand, particularly in our key markets of North America, the United Kingdom, and the European Union. As mentioned in Section 2.2 earlier, Management uses order backlog as an indicator of the short-term future revenue of our Company resulting from already recognized orders.

The Company's order backlog as at May 31, 2020 was approximately $3.6 million. As at September 22, 2020, the Company had an order backlog of approximately $9.3 million.

| | 2018<br>$ million | 2019<br>$ million | 2020<br>$ million |
|---|---|---|---|
| Order backlog as at May 31 | 9.9 | 14.0 | 3.6 |
| Order backlog as at September reporting date | 12.7 | 18.2 | 9.3 |

- On August 18, 2020, the Company announced that it has been commissioned by one of Europe's largest food and drink groups to supply a turnkey heat recovery system designed to reduce fuel use and carbon emissions, while also minimizing particulate matter, and NOx emissions. The project, valued at approximately $920,000, will be installed at a canning and pouch packaging facility in the UK. At the heart of the system will be Thermal Energy's proprietary direct contact heat recovery technology, FLU-ACE®. Once commissioned, the system is expected to deliver an annual fuel saving of $383,300 and reduce the site's carbon emissions by 2,868 tonnes a year.

- On June 10, 2020, the company announced that it had been commissioned by a leading consumer protein company to supply energy efficient equipment and engineering for a plant upgrade project. This equipment, valued at approximately $950,000, will be used to heat process water for the plant operation producing up to 2,700 US gallons per minute of water heated from 85°F to 140°F.

- On August 7, 2019, the company announced that it had been commissioned by a leading European brewer to install a high-efficiency heat recovery system. The FLU-ACE® heat recovery project, valued at over $650,000, is designed to optimize efficiency at the UK production facility, helping the site to reach its sustainability goals. Preliminary analysis shows the initiative will provide an expected utility saving of $400,000 per year. The project was about 40% complete at the year-end.

- On March 27, 2019, the Company announced that it had been commissioned by a leading multinational animal nutrition and agricultural products company to improve energy efficiency at one of its European facilities. The project, valued at approximately $2.3 million, will see the Company install two of its proprietary FLU-ACE® heat recovery systems to delivery greater fuel efficiency. The project was about 72% complete at the year-end.

- On March 11, 2019, the Company announced that it had been commissioned by a major US dairy group to design and implement an extensive heat recovery project. This project, valued at $1.8 million, will utilize the Company's recently acquired HEATSPONGE technology to heat boiler feed and process water. It is the first project between the Company and the diary group. The project was 69% complete at the year-end.

## 7. Summary of Outstanding Shares and Dilutive Instruments

The Company currently has the following shares and dilutive instruments outstanding:

Shares:

160,152,616 class A common shares.

Normal Course Issuer Bid:

On November 19, 2019, the Company announced its intent to re-launch the Normal Course Issuer Bid ("NCIB") for a further period of twelve months. The NCIB was approved by the TSX Venture Exchange on November 18, 2019. During the 12-month period commencing November 22, 2019 and ending November 21, 2020, the Company may purchase on the TSX up to 8,094,280 common shares, representing approximately 5% of the then issued and outstanding common shares. The actual number of common shares purchased, if any, and the timing of such purchases will be determined by the Company by considering market conditions, share prices, its cash position, and other factors. All the purchased Class A common shares were purchased and cancelled directly under the NCIB for the year ended May 31, 2020.

Options:

| | Options outstanding | | | Options exercisable | |
|---|---|---|---|---|---|
| Range of exercise prices | Number outstanding May 31, 2020 | Weighted average remaining contractual life | Weighted average exercise price | Number exercisable at May 31, 2020 | Weighted average exercise price |
| 0.05-0.07 | 2,739,583 | 1.00 | 0.05 | 2,739,583 | 0.05 |
| 0.08-0.10 | 14,831,693 | 3.09 | 0.08 | 5,838,360 | 0.08 |
| 0.11-0.12 | 250,000 | 1.49 | 0.12 | 250,000 | 0.12 |
| | 17,821,276 | 2.75 | 0.07 | 8,827,943 | 0.07 |

## 8. Critical Accounting Estimates and Changes in Accounting Standards

### Critical Accounting Estimates

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expenses. The judgements, estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of the valuation of assets and liabilities that are not readily apparent from other sources. The judgements, estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates and assumptions are recognized in the year in which they are revised and in any future periods affected. Actual results may differ from these estimates, judgements and assumptions.

The COVID-19 outbreak began to impact the Company's operations in the latter half of March 2020. Management believes the extent of the COVID-19 pandemic's adverse impact on the Company's operating results and financial condition will be driven by many factors, most of which are beyond management's control and ability to forecast. Such factors include, but are not limited to, the scope and duration of past and potential future stay-at-home policies and business closures, travel restrictions, and the willingness of customers to allow outside contractors onsite. Because of these and other uncertainties, management cannot estimate the length or severity of the impact of the pandemic on the business. Decreases in cash flows and results of operations may have an impact on the inputs and assumptions used in significant accounting estimates, including management's assessment of future compliance with financial covenants and potential impairments of goodwill, intangible and long-lived assets.

The following components of the financial statements depend most heavily on such management estimates, assumptions and judgment, and any changes in which may have a material impact on the Company's financial condition or results of operations. For more information about certain assumptions and risks that may affect these estimates, assumptions and judgments, please see the "Forward Looking Information" section of this MD&A.

#### *Business combinations*

The identifiable assets acquired and liabilities assumed as part of a business combination are measured at the date of acquisition at their fair values. In estimating fair value, the Company uses market observable data to the extent it is available. In cases when Level 1 inputs are not available, the measurement of fair value involves the selection of an appropriate valuation model and consideration as to the inputs necessary for the valuation model chosen.

#### *Valuation of goodwill and intangible assets and asset impairment*

Goodwill and intangible assets are tested annually for impairment, or earlier if circumstances indicate an impairment.

An impairment loss is recognized for the amount by which an asset's or cash-generating unit's carrying amount exceeds its recoverable amount. To determine the recoverable amount, management estimates expected future cash flows from each asset or cash-generating unit and determines a suitable interest rate in order to calculate the present value of those cash flows. In the process of measuring expected future cash flows, management makes assumptions about future operating results and, in the case of other intangible assets, determines an applicable royalty rate. These assumptions relate to future events and circumstances. The actual results may vary and may cause significant adjustments to the Company's assets within the next financial period.

In most cases, determining the applicable discount rate involves estimating the appropriate adjustment to market risk and the appropriate adjustment to asset-specific risk factors.

### *Future production outputs relating to the finance lease*

When a new finance lease or amendment is signed, in determining minimum lease payments receivable, management makes estimates regarding monthly energy outputs of the leased asset based on assumptions regarding the efficiency of the asset, the operations of the plant in which it is located, penalty payments resulting from temporary plant shut-downs and residual value of the equipment. These assumptions relate to future events and circumstances. Actual results may vary from estimate.

### *Assumptions used in the Black-Scholes fair value calculations*

The estimation of share-based payment expense requires the selection of an appropriate valuation model and consideration as to the inputs necessary for the valuation model chosen. In calculating the share-based payment expense, key estimates such as the rate of forfeiture of options granted, the expected life of the option, the volatility of the Company's stock price, and the risk-free interest rate are used.

### *Expected credit loss*

The valuation of allowances for uncollectable trade receivables requires assumptions including estimated credit losses based on the Company's knowledge of the financial conditions of its customers, historical experience, and general economic conditions.

### *Revenue recognition relating to contracts for heat recovery solutions*

The stage of completion of any heat recovery solutions contract is assessed by management by taking into consideration all information available at the reporting date. In this process, management exercises significant estimate about milestones, actual work performed, and the estimated costs to complete work.

### *Deferred tax assets*

Deferred tax assets are recognized for unused tax losses, tax credits, and deductible temporary differences, to the extent that it is probable that future taxable income will be available against which they can be utilized. These estimates are reviewed at every reporting date. Significant management judgment is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and the level of the reversal of existing differences, future taxable income, and future tax planning strategies.

## Changes in Accounting Policies

Effective June 1, 2019, the Company changed its accounting policy with respect to commissions and reclassified commission expense from selling, marketing and business development expense to cost of sales. The Company believes that the revised policy and presentation provides more reliable and relevant information to users of the consolidated financial statements. The change in accounting policy has been applied retrospectively. The Company has restated the comparative figures in the consolidated statements of operation resulting in reclassification of commission expense in the amount of $1,192,170 for the year ended May 31, 2019 from selling, marketing and business development expense to cost of sales.

## Changes in Accounting Standards

Note 3(x) of the Company's audited consolidated financial statements for the year ended May 31, 2020 discusses IFRS standards and interpretations that became effective for the Company on June 1, 2019.

## 9. Risk Factors and Risk Management

Management is confident about our long-term prospects, but does recognize that the company is exposed to a number of risks in the normal course of business that could negatively impact the financial condition of the Company.

Operational risks of the company include the ability to continue to secure and implement sales contracts for its GEM™ and FLU-ACE® technology solutions.

Financial risks and uncertainties of the Company include:

- The impact of major global pandemics;
- The Company's history of operating losses and uncertainty of future profitability;
- The ability to grow sales through the establishment of new cooperative partnerships and strategic alliances;
- The ability to grow sales through the licensing of the corporation's technologies;
- The ability to secure and maintain the required outside working capital financing;
- The ability to achieve profitable operations through increased sales;
- Reliance on third party collaborations and license arrangements;
- Reliance on proprietary technology;
- Competition in the energy conservation and environmental compliance solutions;
- Product liability claims and insurance;
- Reliance on key personnel;
- The ongoing litigation with its former President & CEO;
- The ability to control costs and achieve a positive gross margin on projects;
- The effect of a continuing prolonged recession in Canada, U.S. and Europe to the financial markets in securing project financing and in particular to industrial and commercial customers in committing capital to projects; and
- The impact of the departure from the European Union by the U.K.

***Management's addressing of the risks:***

FY 2012 saw the Company's first ever net profit, which was the result of increased revenues and strict cost control. FY 2013, however, produced an operating loss of $844,328, resulting from diminished revenues and increasing costs. Despite further cost increases as management continued to build the sales force, FY 2014 produced the company's best ever post-tax income of $634,023 as well as an increase in cash balance of $742,022. However, this was again followed by a net loss of $2,154,817, accompanied by a cash decrease of $1,331,074 in FY 2015. FY 2016 and FY 2017 saw a return to profitability and an increase in cash balances of $427,805 and $1,806,992, respectively. This was followed in FY 2018 by another profitable year which saw cash balances increase by $336,334. In FY 2019, sales increased by 21.1% due to the increased revenue in heat recovery systems and the acquisition of Boilerroom Equipment Inc. In FY 2020, despite of the COVID-19 pandemic, the Company maintained the same sales level as FY 2019 with higher gross margins and recorded operating income before impairment of $1,275,708. The Company reported a loss for the year because of the impairment write-down of $3,061,200 on intangible assets and goodwill.

The Company actively protects its proprietary technology through registered trademarks and confidentiality agreements.

The Company maintains adequate forms of general liability insurance including product liability and errors and omission coverage.

Management still believes that competition against its core technologies is limited at this time and believes that the marketplace is sufficiently large enough to mitigate the risk of stronger competition in the future.

On June 23, 2016, a referendum was held in the U.K., resulting in the decision to leave the European Union ("EU"). The withdrawal of the UK from the EU is also called "Brexit". As at January 31, 2020, UK was no longer a member of the European Union. Even though Brexit happened on January 31, 2020, both the UK and the EU still need to work out the specific rules for their new relationship. This includes everything from trade, immigration, aviation, security and access to fishing waters. These rules must be negotiated and signed off by the EU and UK Parliaments during the 11 months transition period ending on December 31, 2020. When the transition period ends, the UK will automatically drop out of the EU's main trading arrangements (i.e. the single market and the customs union). The single market means that countries share the same rules on product standards and access to services, whereas the customs union is an agreement between EU countries not to charge taxes and tariffs on each other's goods. If a new trade deal is not ready by December 31, 2020, then tariffs and border checks would be applied to UK goods travelling to the EU. The UK could also do this to EU goods, if it chose to. Tariffs would make UK goods more expensive and harder to sell in the EU, while full border checks could cause long delays at ports. Even if a trade deal is reached, it would not eliminate all border checks. Negotiations regarding how trade will continue after December 31, 2020 are ongoing, the outcome of which is difficult to predict. In the meantime, business continues as normal and the UK still follows EU rules. Management continues to monitor the situation, and is exploring alternative solutions to minimize the potential negative impact from Brexit on our business.

Management continues to focus on strengthening relationships with key customers, as well as securing new relationships with multi-site organizations, which is anticipated to provide repeat business into the foreseeable future. Management continually monitors costs and cash flow to ensure that the Company has sufficient funds for operations while providing for future growth.

## 10. Forward-Looking Information

This MD&A contains certain "forward-looking statements." All statements, other than statements of historical fact, that address activities, events or developments that the Company believes, expects or anticipates will or may occur in the future (including, without limitation, statements regarding financial and business prospects and financial outlook) are forward looking statements. These forward-looking statements reflect the current expectations or beliefs of Management, based on information currently available to the Company. Forward-looking statements are subject to a number of risks, uncertainties and assumptions that may cause the actual results of the Company to differ materially from those discussed in the forward-looking statements and, even if such actual results are realized or substantially realized, there can be no assurance that they will have the expected consequences to, or effects on the Company. Factors that could cause actual results or events to differ materially from current expectations include, among other things, changes in general economic and market conditions, changes to regulations affecting the Company's activities, and uncertainties relating to the availability and costs of financing needed in the future. Any forward-looking statement speaks only as at the date on which it is made and, except as may be required by applicable securities laws, the Company disclaims any intent or obligation to update any forward-looking statement, whether as a result of new information, future events or results or otherwise. Although Management believes that the assumptions inherent in the forward-looking statements are reasonable, forward-looking statements are not guarantees of future performance and, accordingly, undue reliance should not be put on such statements due to the inherent uncertainty therein.

## 11. Management's Responsibility for Financial Reporting

In compliance with the Canadian Securities Administrators' National Instrument 52-109 ("NI 52-109"), the Company has filed with applicable Canadian securities regulatory authorities, certificates signed by its Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") that, among other things, report on the design and effectiveness of disclosure controls and procedures, and the design of internal controls over financial reporting.

Under the supervision of the CEO and CFO, the Company maintains systems of internal accounting and administrative controls to provide reasonable assurance that the financial information is relevant, reliable, and accurate, and that transactions are authorized, assets are safeguarded, and proper records are maintained. Internal controls over financial reporting, no matter how well designed, have inherent limitations, and may not prevent or detect all misstatements. There were no changes to the Company's internal control over financial reporting during the year ended May 31, 2020 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

The Board of Directors is responsible for ensuring that management fulfills its responsibility principally through its Audit Committee.