MANAGEMENT'S DISCUSSION & ANALYSIS – 2013

This discussion is dated as of September 16, 2013 and explains the material changes in Thermal Energy International Inc.'s ("Thermal Energy" or the "Company") financial condition and results of operations for the fiscal year ended May 31, 2013 (or FY 2013), and compares the FY 2013 financial results to the previous year ended May 31, 2012 (or FY 2012). The consolidated financial statements and notes to the consolidated financial statements constitute an integral part of the discussion and should be read in conjunction with these comments. This discussion and analysis of the financial condition and results of operations may contain forward-looking statements. Statements about the expected timing of revenue recognition and management's expectations about the Company's ability to continue as a going concern are forward looking statements. 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. Many factors, some of which are outside of the Company's control, could cause events and results to differ materially from those stated. The Company's ability to deliver against orders received to date and the recognition of the revenue associated with those orders could be postponed or delayed for a number of reasons or such orders could be cancelled or revised. Additional information relating to the Company is available on SEDAR at www.sedar.com. All financial information in this report is stated in Canadian Dollars, which is both the presentation and functional currency of the Company.

Description of Business

Thermal Energy, established in 1991, is an innovative cleantech company providing a variety of proprietary and proven energy and water efficiency, emission reduction, and bioenergy products and solutions to the industrial, commercial and institutional markets. Thermal Energy International Inc. is headquartered in Ottawa, Canada, with offices in the UK and China and sales worldwide.

Thermal Energy engages clients through a unique mix of process, energy, environmental, and financial expertise to deliver significant financial and environmental benefits to our customers. 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; lower 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.

Discussion of Operations and Financial Conditions

Fourth Quarter 2013

Revenues in the fourth quarter 2013 were $1,879,450, compared with $3,460,878 for the same period in 2012, a decrease of $1,581,428, or 45.7%. Revenue from heat recovery projects fell by $1,264,229, due mainly to the $5.8 million contract with Fibrek, announced June 16, 2011, which was substantially completed in the final quarter of FY 2012 and accounted for $1,563,040 heat recovery revenue in that period. Heat recovery contracts for a major food manufacturer, which commenced in the fourth quarter of FY 2012, were also substantially completed in the fourth quarter of FY 2013, contributing $317,785 in the current quarter compared to $723,589 in the same period of the previous year. Partially offsetting these decreases was revenue from a major hospital plus another major food manufacturer. Sales of GEM® product meanwhile fell by $317,199. There were no sales to a major pharmaceutical company in the final quarter of FY 2013 compared to $125,788 in the same quarter of the prior year, while sales across Europe were generally down and the rest of the world slightly up on the same quarter of the prior year.

The gross profit in the fourth quarter of FY 2013 was $746,358 (39%) compared with $1,308,407 (38%) for the same period in 2012, a decrease of $562,049, or 43.0%.

Administration and Selling, Marketing and Business Development expenses incurred in the fourth quarter 2013 were $1,282,528, a decrease of $189,298 (12.9%) over the $1,471,826 incurred during the same period in 2012. As well as a decrease in commission resulting from the lower revenues, other cost decreases included legal fees relating to the statement of claim filed against the Company by a past president, bad debts written off and foreign exchange losses.

Research and development expenses in the quarter ended May 31, 2013 were $19,865 compared to $nil in the quarter ended May 31, 2012. FY2013 saw an increase in R&D activity across a number of projects including the ISTP project in China, as announced February 7, 2013.

Impairment of goodwill in the quarter ended May 31, 2013 was $2,166,000, resulting from the annual impairment testing performed at year end. There was no such charge for the same quarter of the previous year. The impairment is the result of lower revenues over the last two years caused by a re-organization of the UK based sales group, including two key UK sales managers relocating to North America, plus the global recession which continues to impact the European economy particularly hard.

Impairment of other intangible assets in the quarter ended May 31, 2013 was $139,000, resulting from the annual impairment testing performed at year end. There was no such charge for the same quarter of the previous year. The intangible assets are specifically Names and Trademarks relating to the GEM® product. As with the goodwill impairment, the impairment charge in the current quarter is the result of lower revenues over the last two years caused by a re-organization of the UK based sales group plus the global recession which continues to impact the European economy particularly hard.

Finance revenue in the final quarter of FY 2013 was $51,452, compared with $16,915 in the same period of the previous year. The increase of $34,537 was a consequence of the extension to the Greenpower Purchase Agreement with Fortress Specialty Cellulose, as announced November 29, 2012, for a further two years.

Net loss for the fourth quarter 2013 was $2,686,556 compared with $26,341 for the same period in FY 2012, mainly as a result of the decrease in gross profit, partially offset by a reduction in Administration and Selling, Marketing and Business Development expenses, plus the impairment of both goodwill and intangible assets at the year end date

The Company's net cash position (Cash and cash equivalents less Bank loans) in the fourth quarter increased by $603,691 while working capital decreased by $223,721 from $1,775,742 as at February 28, 2013 to $1,552,021 as at May 31, 2013. The decrease in working capital is primarily the result of the cash outflow from operations defined as net loss, plus items not involving cash, plus lease payments received. Cash outflow from operations for the quarter was $248,350.

Fiscal Year 2013

Revenues and Gross Profits

Revenues were $8,210,234 in FY 2013 compared to $13,152,687 in FY 2012, a decrease of $4,942,453, or 37.6%. Sales of heat recovery systems decreased in the year by $4,995,348 (51.4%), while sales of GEM® Condensate return systems increased by $52,895 (1.5%).

Of the $9,713,338 heat recovery systems revenues achieved in FY 2012, $5,731,021 related to the Fibrek contract, announced June 16, 2011 and $2,066,194 related to St. Georges Healthcare NHS Trust in the U.K., announced August 5, 2011. FY 2013 had no replacement for the Fibrek contract, although it did see one major hospital contract fulfilled with a value of $1,038,074 plus two smaller hospital contracts replacing the smaller two hospital projects in the prior year. In addition, FY 2013 heat recovery systems revenue included $1,561,998 relating to the capitalization of the Greenpower Purchase Agreement extension with Fortress Specialty Cellulose, as announced November 29, 2012.

GEM® Condensate return systems sales in FY 2013 were $3,492,244 compared to $3,439,349 in FY 2012. Decreases included $161,266 from a major pharmaceutical company and $157,347 from a major food manufacturer as well as general decreases in UK and the rest of the world due to a lack of coverage and the depressed economy in general. These decreases were offset by an increase in sales to major hospitals of $460,610 plus the continuing growth of GEM® sales in North America.

The gross profit of $4,977,452 in FY 2013 represented a decrease of $670,919, or 11.9%, from the $5,648,371 achieved in FY 2012. These results expressed as a percentage of sales were 60.6% in FY 2013 compared with 42.9% in FY 2012. The improvement in gross profit as a percentage of sales is partly a result of a higher proportion of revenues coming from sales of GEM® Condensate return systems, which generates higher margins than sales of waste energy recovery systems and partly due to the capitalization of the Greenpower Purchase Agreement extension with Fortress Specialty Cellulose, which carries little cost.

Expenses

Administration and Selling, Marketing and Business Development expenses in FY 2013 totaled $5,637,392 compared to $5,619,590 in FY 2012, an increase of $17,802, or 0.3%. Increases resulting from the additional roles created during the year, plus the retainer paid to the investor relations firm, as announced April 19, 2012, were offset by decreases in legal fees relating to the statement of claim filed against the Company by a past president, as well as audit fees relating to the transition to reporting in accordance with International Financial Reporting Standards and the write down of the net investment in lease following a permitted plant shutdown at the site, both incurred in FY 2012, plus a decrease in foreign exchange losses due to the strengthening of the Euro against Sterling compared to the previous year. In addition, in FY 2012 the Company paid court costs attributed to the former president totaling $36,879.

Research and development costs increased in FY 2013 to $184,388 compared to $8,455 in FY 2012. A renewed focus was placed on R&D activity in the current year, particularly with regard to the product development project targeting the Chinese petrochemical market, for which the Company had previously received an offer of government funding through ISTP Canada, as announced February 8, 2012. The funding agreement was signed by both parties on January 21, 2013. Funding will be credited to research and development costs when it is received. Research and development costs also include time spent on the development of sundry ancillary products relating to the GEM® product range.

Impairment of goodwill in the year ended May 31, 2013 was $2,166,000, resulting from the annual impairment testing performed at year end. There was no such charge in the previous year. The impairment is the result of lower revenues over the last two years caused by a re-organization of the UK based sales group, including two key UK sales managers relocating to North America, plus the global recession which continues to impact the European economy particularly hard.

Impairment of other intangible assets in the year ended May 31, 2013 was $139,000, resulting from the annual impairment testing performed at year end. There was no such charge in the previous year. The intangible assets are specifically Names and Trademarks relating to the GEM® product. As with the goodwill impairment, the impairment charge in the current year is the result of lower revenues over the last two years caused by a re-organization of the UK based sales group plus the global recession which continues to impact the European economy particularly hard.

Finance revenue was $108,456 in FY 2013 compared to $102,956 in FY 2012. As announced November 29, 2012, the Greenpower Purchase Agreement with Fortress Specialty Cellulose was extended for a further two years from December

2012. The interest rate implicit in the lease of 14% is applied against the reducing finance lease receivable balance, hence lower finance revenues as the term of the agreement progresses.

Loss before income taxes for FY 2013 was $3,040,872 compared to net income of $123,282 in FY 2012.

Net income tax recovery for FY 2013 was $192,050, compared to an expense of $38,551 in FY 2012. The FY 2012 charge represents taxes payable in the United Kingdom by the Company's wholly owned subsidiary Thermal Energy International (UK) Ltd (formerly Gardner Energy Management Ltd) of $91,221 net of a credit of $52,670 reflecting the reduction in the future tax liability related to intangible assets. Thermal Energy International (UK) Ltd incurred a loss in FY 2013 resulting in an income tax rebate against the prior year tax charge and future expected tax charge. In addition, in FY 2013 there was a credit of $98,910 reflecting the reduction in the future tax liability related to intangible assets.

Comprehensive loss attributable to owners of the parent was $2,870,331 in FY 2013 compared to income of $87,544 in FY 2012. The continued weakening of the Pound Sterling during FY 2013 served to reduce the value of goodwill and intangibles which were acquired in Sterling.

Liquidity & Capital Resources

The working capital was $1,552,021 as at May 31, 2013 compared to working capital of $2,567,447 at the end of FY 2012 - a decrease of $1,015,426, while the Company's net cash position (Cash and cash equivalents less Bank loans) decreased by $67,556 from $1,371,951 at the end of last year to $1,304,395 as at the end of FY 2013. The decrease in working capital has been primarily driven by the Company's negative cash flow from operations (defined as net income, plus items not involving cash, plus lease payments received, adjusted for the capitalization of the Greenpower Purchase Agreement extension) which totaled $1,243,565 for the year.

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

	Aug 31, 2011 $	Nov 30, 2011 $	Feb 29, 2012 $	May 31, 2012 $	Aug 31, 2012 $	Nov 30, 2012 $	Feb 28, 2013 $	May31, 2013 $
Current Assets	4,371,855	5,813,077	5,345,538	5,758,086	4,534,637	3,814,265	4,537,306	3,642,680
Current Liabilities	2,695,481	3,500,526	2,942,432	3,190,639	2,800,733	2,770,537	2,761,564	2,090,659
Working Capital	1,676,374	2,312,551	2,403,106	2,567,447	1,733,904	1,043,728	1,775,742	1,552,021

FY 2013 changes

Current assets decreased by $2,115,406 to $3,642,680. This was mainly due to a decrease in trade receivables of $1,990,393 following the receipt of payment of invoices to Fibrek outstanding as at May 31, 2012. The reversal of $181,661 of deposits for equipment and $103,756 relating to amounts due from customers for contract work relating to waste energy recovery contracts which were completed within FY 2013 also contributed to the decrease, along with other net decreases of $88,504. These decreases were tempered by an increase in the current portion of the Net Investment in Lease of $248,908 following the extension of the Greenpower Purchase Agreement. Current liabilities meanwhile also decreased by $1,099,980 to $2,090,659, due to the settlement of liabilities relating to subcontractors on the Fibrek project of $839,640, and a reduction in deferred revenue of $306,813, mainly from customer deposits on waste energy recovery projects fulfilled in FY 2013, less other sundry net increases of $46,473.

As noted above, net cash outflow from operations (defined as net income, plus items not involving cash, plus lease payments received, adjusted for the capitalization of the Greenpower Purchase Agreement extension) for the year ended May 31, 2013 totaled $1,243,565. After adjusting this for $1,196,778 of positive changes in non-cash working capital items; and deducting $21,078 to acquire fixed assets plus $309 exchange differences on cash and cash equivalents, the net cash outflow was $67,556, decreasing the net cash balance as at May 31, 2013 to $1,304,395 from $1,371,951 as at May 31, 2012.

In addition to its net cash balance of $1,304,395 as at May 31, 2013 the Company also had an estimated $55,000 of unused borrowing capacity under its bank loans.

With cash balances and unused borrowing capacity of approximately $1,359,395, plus the extended Greenpower Purchase Agreement plus orders received to date which have not yet been recognized as revenue, management believes that it has sufficient capital resources to fund existing operations and anticipated capital requirements in FY 2014.

Order backlog as at May 31, 2013 was approximately $1.4 million, the same as the same time last year. As at September 16, 2013, the Company had an order backlog of approximately $8.6 million, of which approximately $0.5 million is related to long term contracts and is not expected to be reflected in revenue within the next 12 months. 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 quarterly financial statements.

Net Investment in Lease

The Company's net investment in lease includes the following:

	May 31, 2013 $	May 31, 2012 $
Total estimated minimum lease payments receivable	1,507,952	530,779
Less: unearned income	(161,351)	(18,283)
	1,346,601	512,496
Less: current portion	(761,404)	(512,496)
	585,197	-

On December 31, 2012, the lease with Fortress Specialty Cellulose, as signed on June 29, 2010, expired. On November 27, 2012 an agreement was signed whereby the customer agreed to purchase the recovered energy for a further two years, after which the customer has the option to renew for an additional 24 months on substantially the same terms or purchase the asset from the Company. This new agreement was recorded in accordance with the previous lease, resulting in an increase to net investment in lease, plus associated revenue relating to the capitalization of the lease during the year ended May 31, 2013 of $1,546,318. In subsequent periods until the expiry of the new lease on December 31, 2014, finance revenue will be recognized within the income statement at the interest rate implicit in the lease. 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 and the operations of the plant in which it is located.

Future estimated minimum lease payments receivable, and expected residual value of equipment at the end of the lease, under the sales-type lease are as follows:

	$
Less than one year	898,921
Between two and five years	469,501
Residual value of equipment	139,530
	1,507,592

The estimated residual value of the equipment at the end of the new lease has been determined by assigning depreciation rates to various pieces of the equipment in order to derive a reasonable expected selling price or re-use value for the equipment upon the termination of the agreement. The residual value of the equipment is not guaranteed.

Related Party Transactions

Options outstanding for Directors (excluding the CEO) as at May 31, 2013 were 1,500,000 of which 333,334 were exercisable. There were no warrants outstanding for Directors.

Options outstanding for Officers (including the CEO) as at May 31, 2013 were 5,430,000 of which 2,946,667 were exercisable. There were no warrants outstanding for Officers.

Officer and Director Compensation

During the year ended May 31, 2013 compensation arrangements for directors were as follows:

Before October 26, 2012:

$20,000 per annum per Director plus an additional $12,000 per annum payable to the Chairman of the Board, $8,000 per annum payable to individual committee chairpersons of the Audit Committee and the Ethics, Governance and Compliance Committee, and $1,000 payable for each in-person meeting.

After October 26, 2012:

$15,000 per annum per Director plus an additional $9,000 per annum payable to the Chairman of the Board, $6,000 per annum payable to the chairperson of the Audit Committee and $1,000 payable for each in-person meeting.

Compensation paid to directors and officers during the year ended May 31, 2013 (inclusive of the amounts described above) was as follows:

	Salaries and fees		Commissions / incentives		Total	
	2013 $	2012 $	2013 $	2012 $	2013 $	2012 $
Directors						
M. Williams	27,804	34,000	-	-	27,804	34,000
J. Ansell	12,214	34,000	-	-	12,214	34,000
J. Kelly	32,203	38,000	-	-	32,203	38,000
D. Gibbs	22,003	24,335	-	-	22,003	24,335
W. Ollerhead	22,003	16,084	-	-	22,003	16,084
B. Linton	11,993	-	-	-	11,993	-
J. Schoenmakers	11,993	-	-	-	11,993	-
Total	140,213	146,419	-	-	140,213	146,419
Officers						
W. Crossland	240,000	240,000	-	20,723	240,000	260,723
J. Flynn	126,556	123,907	-	10,137	126,556	134,044
R. Triebe	139,051	135,000	-	10,137	139,051	145,137
Total	505,607	498,907	-	40,997	505,607	539,904

Segmented Information

In fiscal 2013 and 2012, 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, Europe and China.

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, United Kingdom, 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, 2013 and the comparative year are detailed in the table below.

	North America and China		Europe and Rest of World		Reconciling Items		Total	
	2013 **$**	2012 $	**2013** **$**	2012 $	**2013** **$**	2012 $	**2013** **$**	2012 $
Total revenue from external customers	**3,124,092**	7,235,139	**5,086,142**	5,917,548	**-**	-	**8,210,234**	13,152,687
Cost of sales	**(781,190)**	(5,095,752)	**(2,451,592)**	(2,408,564)	**-**	-	**(3,232,782)**	(7,504,316)
Gross profit	**2,342,902**	2,139,387	**2,634,550**	3,508,984	**-**	-	**4,977,452**	5,648,371
Amortization of intangible assets	**-**	-	**(98,295)**	(99,126)	**-**	-	**(98,295)**	(99,126)
Impairment of goodwill	**-**	**-**	**(2,166,000)**	-	**-**	-	**(2,166,000)**	-
Impairment of other intangible assets	**-**	**-**	**(139,000)**	-	**-**	-	**(139,000)**	-
Other expenses	**(2,048,389)**	(1,738,315)	**(2,452,556)**	(2,323,389)	**(1,222,540)**	(1,467,215)	**(5,723,485)**	(5,528,919)
Finance revenue	**108,456**	102,956	**-**	-	**-**	-	**108,456**	102,956
Income (loss) before taxation	**402,969**	504,028	**(2,221,301)**	1,086,469	**(1,222,540)**	(1,467,215)	**(3,040,872)**	123,282
Tax (expense) recovery	**(57,517)**	-	**105,892**	(174,337)	**143,675**	135,786	**192,050**	(38,551)
Profit (loss) after taxation	**345,452**	504,028	**(2,115,409)**	912,132	**(1,078,865)**	(1,331,429)	**(2,848,822)**	84,731
Attributable to:								
Owners of the parent	**374,050**	529,695	**(2,120,208)**	903,163	**(1,078,865)**	(1,331,429)	**(2,825,023)**	101,429
Non-controlling interest	**(28,598)**	(25,667)	**4,799**	8,969	**-**	-	**(23,799)**	(16,698)

Reconciling items comprise the following:

	Year ended May 31	
	2013	2012
	$	$
Corporate admin costs	**832,155**	873,650
Stock-based compensation	**152,977**	123,105
Professional fees	**141,325**	324,496
Depreciation of property, plant and equipment	**45,623**	45,851
Bank charges and interest	**39,346**	43,304
Foreign exchange differences	**11,114**	56,809
Total	**1,222,540**	1,467,215

During the year ended May 31, 2013, the company had one customer in Europe and Rest of World that accounted for 17% of total revenue for the year.

During the year ended May 31, 2012, the Company had one customer in North America and China that accounted for 44%, and one customer in Europe and the rest of world that accounted for 16% of total revenue for the year.

Further geographical analysis:

	Revenues for the year ended		Property, plant and equipment		Goodwill and other intangibles assets		Finance lease receivable	
	2013	2012	**2013**	2012	**2013**	2012	**2013**	2012
	$	$	**$**	$	**$**	$	**$**	$
Canada	**1,873,417**	6,042,926	**22,301**	28,448	**-**	-	**585,197**	-
U.S.A.	**1,198,950**	1,130,002	**-**	-	**-**	-	**-**	-
U.K.	**4,358,514**	4,934,749	**23,169**	40,512	**1,706,449**	4,145,745	**-**	-
Italy	**199,060**	541,255	**-**	-	**-**	-	**-**	-
Ireland	**103,841**	77,857	**-**	-	**-**	-	**-**	-
Netherlands	**91,683**	116,665	**-**	-	**-**	-	**-**	-
Germany	**13,863**	31,809	**-**	-	**-**	-	**-**	-
Rest of Europe	**45,397**	31,999	**-**	-	**-**	-	**-**	-
India	**156,970**	35,193	**-**	-	**-**	-	**-**	-
China	**51,725**	62,211	**-**	1,364	**-**	-	**-**	-
Kenya	**44,311**	2,140	**-**	-	**-**	-	**-**	-
Turkey	**23,531**	6,647	**-**	-	**-**	-	**-**	-
Pakistan	**22,874**	19,427	**-**	-	**-**	-	**-**	-
Singapore	**6,960**	63,316	**-**	-	**-**	-	**-**	-
Rest of world	**19,138**	56,491	**-**	-	**-**	-	**-**	-
Total	**8,210,234**	13,152,687	**45,470**	70,324	**1,706,449**	4,145,745	**585,197**	-

Material Segmentation Variances

Revenue

North America and China: total revenue for this segment in FY 2013 was $3,124,092, representing a decrease of $4,111,047 from the prior year. Revenue from sales of heat recovery systems fell by $4,139,823 from FY 2012. FY 2012 included an extra $5,691,486 relating to the contract with Fibrek. Partially offsetting this deficit was $1,561,998 resulting from the capitalization of the Greenpower Purchase Agreement with Fortress Specialty Cellulose in the third quarter of FY 2013. GEM® revenues increased by $28,776 in the year ended May 31, 2013 over the previous year, representing a fall in sales to a major pharmaceutical customer of $71,712 with an increase in general sales within North America and China of $100,488, or 10.9%, over the previous year.

Europe and Rest of World: total revenue in FY 2013 for this segment was $5,086,142, compared with $5,917,548 in FY 2012, a decrease of $831,406. Waste energy recovery systems revenue decreased by $855,525, mainly due to the St. George's NHS Trust project in FY 2012 with a value of $2,066,194 being replaced in FY 2013 by one major hospital project at $1,038,074. GEM® revenues increased by a net $24,119, representing an increase in sales to major hospitals of $460,610 over the previous year but decreases from the major pharmaceutical company with whom a key supplier agreement was signed in 2008, and from a major food manufacturer as the bulk of the order was fulfilled in prior years, plus a general lack of activity in Europe caused by both a lack of coverage and the continuing recession.

Segment profit before tax:

North America and China realized a pre-tax income of $402,969 in FY 2013, a decrease of $101,059 from the preceding year. Despite a reduction in revenue for the region, gross profit increased by $203,515 as a result of the extension of the Greenpower Purchase Agreement which carried little direct cost. Other expenses grew by

$310,074, or 17.8%, from last year, mainly from the addition of one finance and one sales staff plus increased travel costs into the U.S. for the purpose of developing heat recovery projects. Finance revenue increased by $5,500 from the previous year.

Europe and rest of the world loss before tax of $2,221,301 in the year ended May 31, 2013 represented a fall of $3,307,770 from the previous year, which showed income of $1,086,469. Gross profit fell by $874,434, due to higher margins achieved in the prior year on heat recovery projects, and an increase in other expenses of $129,167 brought the overall net income down. The increase in other expenses in FY 2013 came from an increase in staff numbers. In addition, the impairment of goodwill and other intangible assets contributed $2,305,000 to the decrease in profitability during the current year.

Other expenses within Reconciling Items, which incorporates all costs not specifically attributable to the either regional operational center, decreased in FY 2013 from the previous twelve month period by $244,675. This decrease was predominantly due to lower legal fees relating to the statement of claim filed against the Company by a past president, plus additional audit fees in the prior year as a result of the conversion to reporting under International Financial Reporting Standards and foreign exchange expense, which was lower in the current year due to a weakening of the Pound Sterling against the Dollar.

Supplementary Financial 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, 2011, 2012 and 2013

	2011 $	2012 $	2013 $
Revenue	9,700,596	13,152,687	8,210,234
Gross Profit	4,674,618	5,648,371	4,977,452
Gross Profit Percentage	48.2%	42.9%	60.6%
EBITDAS(1)	110,080	449,142	(435,049)
Total net income (loss) attributable to owners of the parent	(142,582)	101,429	(2,825,023)
Net profit (loss) per share – basic and diluted	(0.001)	0.001	(0.017)
Total assets	8,698,963	9,974,155	6,032,496
Total long term financial liabilities	0	0	0
Cash dividends declared per share	0.00	0.00	0.00
Net operating cash flow(2)	587,516	903,315	(1,243,565)

(1) 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.

(2) Net operating cash flow represents net income (loss) plus items not involving cash, plus lease payments received, adjusted for the capitalization of the extended Greenpower Purchase Agreement.

In FY 2013, revenues fell by $4,942,453, mainly due to the Fibrek project and the St. George NHS project which, combined, provided $7,797,215. That said, the year saw three major hospitals ordering heat recovery systems, matching the number of sites in the previous year, plus the extension of the Greenpower Purchase Agreement contributed $1,561,998 towards revenue, with very little associated cost. Although revenue fell by $4,942,453, gross profit only decreased by $670,919 due to the profit recognized with respect to the Greenpower Purchase Agreement extension. This meant an improvement on gross profit as a percentage of revenues from 42.9% in FY 2012 to 60.6% in FY 2013. Other expenses increased mainly as a result of increased staff numbers plus the impairment charges relating to goodwill and other intangible assets. Total assets decreased by $3,941,659 during FY 2013, due mainly to cash received from outstanding Fibrek invoices as at May 31, 2012 being used to settle outstanding liabilities relating to Fibrek, as well as tax liabilities relating to FY 2012 and other accrued payments, plus the reduction in goodwill and other intangible assets relating to the impairment charges recorded in the year.

FY 2012 saw revenues increase by $3,452,091 and produced the first ever net profit attributable to owners of the parent of $101,429. The increased sales resulted in an increase in gross profit of $973,753. This was diminished by increased expenses, mainly from the need to increase the numbers of sales and supporting staff. Although a number of new staff were sales staff, revenues (and consequently profits) will not be immediately enjoyed, due to the learning curve associated with our business and so, certainly initially at least, these additions will serve to reduce net income. Total assets increased by $1,275,192 in the year due mainly to outstanding invoices receivable on the Fibrek project at year end.

In FY 2011, net loss attributable to owners of the parent decreased by $2,929,269 from the prior year. Revenues increased by $3,887,941, resulting in an increase in gross profit of $1,117,311. The non-recurrence of write offs and provisions of $963,213 in FY 2010, coupled with a future tax recovery of $107,915 plus savings in other expenses contributed a further $1,811,958 to the reduction in loss. Total assets increased by $3,694 in the year due mainly to the strengthening of Sterling against the Canadian Dollar as at the year end.

Quarterly financial information (unaudited)
For the eight quarters ended May 31, 2013

Quarter ended	31-May-13 $	28-Feb-13 $	30-Nov-12 $	31-Aug-12 $
Revenue	1,879,450	4,208,723	1,259,984	862,077
Gross Profit	746,358	2,906,414	799,717	524,963
Gross Profit Percentage	39.7%	69.1%	63.5%	60.9%
EBITDAS(1)	(424,414)	1,573,398	(682,929)	(901,104)
Total net income (loss) attributable to owners of the parent	(2,685,427)	1,476,814	(778,011)	(838,399)
Income (loss) per share, basic and diluted	(0.016)	0.009	(0.005)	(0.005)
Net operating cash flow(2)	(223,741)	185,249	(536,159)	(668,914)

Quarter ended	31-May-12 $	29-Feb-12 $	30-Nov-11 $	31-Aug-11 $
Revenue	3,460,878	3,583,801	4,676,322	1,431,686
Gross Profit	1,308,407	1,413,265	2,123,687	803,012
Gross Profit Percentage	37.8%	39.4%	45.4%	56.1%
EBITDAS(1)	(61,525)	44,242	731,191	(264,766)
Total net income (loss) attributable to owners of the parent	(20,941)	(28,913)	459,779	(308,496)
Income (loss) per share, basic and diluted	0.000	0.000	0.003	(0.002)
Net operating cash flow(2)	216,353	236,363	609,587	(158,988)

(1) 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.

(2) Net operating cash flow represents net income (loss) plus items not involving cash, plus lease payments received.

Trend Analysis:

The final quarter of FY 2013, ended May 31, 2013, experienced a drop in revenue of $2,329,273 from the previous quarter, which had seen the Fortress Greenpower Purchase Agreement extension plus the completion of the installation of a heat recovery system at a major hospital, providing a combined revenue of $2,600,072. This decrease in heat recovery systems revenue was offset by $700,574 coming from other heat recovery projects, including the commencement of a further major hospital conversion plus the completion of an installation at a major food and beverage manufacturer. GEM® sales meanwhile fell by $429,775 from the third quarter due to the third quarter including a full site conversion at the major hospital at which the heat recovery system was also installed in Q3. The impairment charge which resulted from the annual testing for impairment of both goodwill and other intangible assets was recorded in the final quarter of FY 2013. This charge is a non-cash item and therefore did not adversely affect either the cash balance or EBITDAS. As other expenses remained at a similar level to the third quarter, other than commission payable, the resulting reduction in EBITDAS was directly related to the reduction in revenue. Due to the UK subsidiary making a loss in the final quarter, the change in total net loss/income was eased by a provision for recoverable income tax.

The third quarter of FY 2013 produced $2,948,739 more revenue than the second quarter. Heat recovery revenues increased by $3,094,436, with $1,546,318 relating to the Fortress Greenpower Purchase Agreement extension, $230,757 relating to the sale of equipment to a major UK food manufacturer and $1,295,113 relating to sales to the National Health Service in the UK. GEM® sales fell in the quarter by $145,697, despite an increase in sales to the National Health Service, due to unusually higher sales within the rest of the world plus a site conversion to a major pharmaceutical manufacturer in the second quarter. As a result of these increased revenues, in particular the Greenpower Purchase Agreement extension, gross profit rose in the third quarter by $2,106,697 over the previous quarter. EBITDAS increased by $2,256,327, slightly better than the gross profit increase due to the prior quarter expenses including invoices relating to the audit of the FY 2012 financial statements and the AGM. Net income of $1,476,814 in the third quarter represented an improvement of $2,254,825 over the second quarter.

Revenues increased in the second quarter of FY 2013 by $397,907 over the previous quarter. A slight decrease in heat recovery revenues was more than compensated for by an increase in GEM® revenues, mainly due to an increase in revenues from sales to the NHS in the UK, plus increased sales within the rest of the world. The effect of this revenue increase on gross profit was an additional $274,754 over the previous quarter. EBITDAS saw an improvement of $218,175 - $56,579 less than the gross profit increase, mainly due to costs in the second quarter relating to the AGM, as well as increased commissions on the increased GEM® sales plus the receipt of invoices relating to the audit of the FY 2012 financial statements. The decrease in net loss of $60,388 was less than the EBITDAS improvement as a result of UK tax losses being absorbed in the first quarter, allowing for no further tax credit from previous years despite losses incurred in the current year.

In the first quarter of FY 2013, revenues fell from the last quarter of FY 2012 by $2,598,801, representing mainly heat recovery revenue from Fibrek and GEM® revenues from UK sites of a major food manufacturer realized in the quarter ended May 31, 2012. The consequent reduction in gross profit of $783,444 along with a slight increase in other expenses net of finance revenue of $34,014, resulted in an increased loss of $817,458 over the previous quarter. Historically, the first quarter of the year has relatively lower GEM® sales than in other quarters due to summer vacations, and management had forecast a significant loss in this quarter.

Revenues in the quarter ended May 31, 2012 decreased again from the quarter ended February 29, 2012 by $122,923. 74% of the revenue in this quarter came from heat recovery systems sales; mainly Fibrek and two UK sites of a major food manufacturer. GEM® revenues increased by $71,065 over the previous quarter. Although expenses remained fairly constant from the third to the fourth quarter, due to less revenue being generated in the UK entity, there was a reversal of tax charge. In addition, a reduction in the UK rate of tax served to reduce the value of the future tax liability against intangible assets, thus creating a credit to the tax charge on the fourth quarter, and reducing the effect of the reduction in revenue.

The quarter ended February 29, 2012 experienced a decrease in revenues of $1,092,521 over the previous quarter, represented by a decrease in heat recovery revenues of $1,168,074 and a small increase in GEM® revenues of $75,553. The majority of the heat recovery decrease related to the St. George's project in the UK, which was substantially completed in the second quarter. The majority of the GEM® related increase came from general UK and Rest of World sales. Expenses decreased in the third quarter from the previous quarter by $59,606, mostly the result of reduced incentive related to the reduced net income for the period.

The second quarter of FY 2012 saw an increase in revenues of $3,244,636 over the previous quarter, resulting from an increase in heat recovery revenues of $3,395,794 and a reduction in GEM® revenues of $151,158. GEM® revenues relating to the orders from the major food manufacturer and the global pharmaceutical company were $227,730 and $74,711 respectively less in the second quarter than the quarter ended August 31, 2011, while revenues from the NHS and other general sales were up $74,607 and $47,860 respectively over the prior quarter. The increase in heat recovery revenues over the first quarter came predominantly from St. Georges Healthcare NHS Trust in the U.K. contributing $1,607,234, and Fibrek, which generated an extra $1,775,452 over the previous quarter. Resulting gross profit represented an increase of $1,320,675 over the $803,012 generated in the first quarter. Net profit before tax for the second quarter of FY 2012 was $622,412 – an improvement of $938,594 over the net loss before tax in the first quarter of $316,182. Costs increased by $382,081 over the prior quarter, mainly the result of increased commissions on the increased revenues, incentive accrued on the profit made in the year to date, audit bills, legal fees relating to the dispute with a former president of the company and other issues, the write off of the finance lease receivable of approximately $54,758 and the recruitment of two new heat recovery sales people; one based in North America and the other covering the U.K. and Europe. These increases were partially offset by a tax credit of around $52,000 relating to historical research and development expenditure.

The first quarter of Fiscal Year 2012 experienced a drop in revenue of $481,477 over the previous quarter to $1,431,686. Of this revenue, $913,665 related to sales of GEM® product, representing a decrease from the previous quarter of $574,088. $309,189 of this decrease was due to a significant proportion of the sales to the major food manufacturer in the UK being recognized in Q4 of Fiscal 2011, $191,246 related to sales to the NHS in the UK, with one hospital order in the quarter ended February 28, 2011 compared with three in the quarter ended May 31, 2011, and other general sales worldwide being down $103,675, except for sales to the major pharmaceutical company which increased by $30,022 over the previous quarter. Revenue from sales of heat recovery solutions in the quarter ended February 28, 2011 increased by $92,611 over the previous quarter. Of the order from Salisbury District Hospital Trust, announced April 11, 2011, $321,752 was recognized as revenue in the first quarter of FY 2012. This more than replaced the revenue from Qinchunbao of $159,972 in the previous quarter, but the decrease of other smaller projects served to reduce the overall increase. These reductions in overall revenue of $481,477 resulted in a decreased gross profit from the previous quarter of $252,025. Net loss increased in the first quarter of FY 2012 over the previous quarter by $257,702, due to the decrease in gross profit, plus $26,248 audit fees paid in the first quarter. There were no other large fluctuations in costs during the quarter.

Disclaimer

The information provided in this document is not intended to be a comprehensive review of all matters concerning the Company. It should be read in conjunction with all other disclosure documents provided. No securities commission or regulatory authority has reviewed the accuracy or adequacy of the information presented herein and, as noted in the consolidated financial statements ended May 31, 2013, these statements were subject to an audit by our independent public accountants.

Business Risks

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 Corporation include:

- 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; and,
- The effect of a continuing prolonged recession in Canada, USA and Europe to the financial markets in securing project financing and in particular to industrial and commercial customers in committing capital to projects.

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, has produced an operating loss of $844,328, resulting from diminished revenues and increasing costs. The increased costs predominantly relate to increased staff numbers, which management believes are vital to maintain and build on the record revenues of FY 2012. A dip in profitability was expected while new staff additions become accustomed to their roles and the strategy of the Company.

As reported last year, on June 29th, 2010 the Company signed an arm's length Greenpower Purchase Agreement with Fortress Specialty Cellulose Inc. ("Fortress Specialty"). The agreement was to supply recovered energy to the Fortress Specialty mill in Thurso, Quebec from a FLU-ACE® Waste Heat Recovery System installed at the site. Based on the amount of heat expected to be recovered, this agreement was expected to provide the Company approximately $720,000 of additional cash flow per year between then and December 31, 2012, which it did in fact achieve. On November 27, 2012, both parties signed an amendment to the agreement, extending the term by a further two years. Upon completion of the extended term, Fortress Specialty has an option to further extend for up to a maximum of 24 months on substantially the same terms or purchase the FLU-ACE® Waste Heat Recovery System from Thermal Energy. Based on the amount of heat expected to be recovered, this extension will provide the Company with approximately $898,000 cash per year between January 2013 and December 2014. The extension has been recorded in the financial statements as an increase to the net investment in lease. The revenue for the year ended May 31, 2013 therefore includes the capital element of the total expected payments over the 24 month period of the extension, totaling $1,546,318. The interest element of the lease will be recorded as finance revenue over the period of the lease.

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 believes that competition against its core technology of GEM®, FLU-ACE® and DRY-REX™ is limited at this time and believes that the market place is sufficiently large enough to mitigate the risk of stronger competition in the future.

Business Outlook

- In June 2012, the Company received another purchase order for approximately $249,000 from a major food manufacturer for a heat recovery solution at one of its sites. This order was partially completed in FY 2013 and is expected to be completed by the second quarter of FY 2014.

- In June 2012, the Company received an order for approximately $562,000 from a publicly owned hospital for a heat recovery solution. This order was partially completed in FY 2013 and is expected to be completed by the third quarter of FY 2014.

- On December 14, 2012, the Company announced it had received a first purchase order totaling approximately $300,000 for the installation of a heat recovery system at a food and beverage company. The project was substantially completed in FY 2013. Thermal Energy is working on a number of additional sites within the company.

- On December 18, 2012, the Company announced it had received a purchase order valued at approximately $750,000 for the installation of a heat recovery system at a large publicly funded hospital. This order was partially completed in FY 2013 and is expected to be substantially completed by the first quarter of FY 2014.

- On June 3, 2013, the Company announced it had received a purchase order valued at approximately $3.6 million for the installation of a heat recovery system at a major North American pulp and paper company. The heat recovery system is expected to be installed and revenue earned by the end of FY 2014.

- On June 13, 2013, the Company announced it had received new GEM® steam trap system and heat recovery system orders totalling approximately $800,000 from a major publicly owned hospital. The GEM® steam trap and heat recovery systems are expected to be installed and revenue earned by the first and third quarters of FY 2014 respectively.

- On July 3, 2013, the Company announced it had received a purchase order valued at approximately $480,000 for GEM® steam traps from a major multinational food and beverage company. The order is to replace the entire steam trap system at one of the company's manufacturing facilities and revenue is expected to be earned by the second quarter of FY 2014. The order is the result of a strategy to target large multinational manufacturers.

- On September 10, 2013, the Company announced it had received orders for both the installation of a heat recovery system and the supply and installation of GEM® steam traps at a large publicly funded hospital. The orders total approximately $780,000 and are expected to be installed and revenue earned over the next six months.

- On September 16, 2013, the Company announced it had received orders totaling approximately $1.7 million for the installation of heat recovery systems at two sites and the supply and installation of GEM® steam traps at one site of a Fortune 500 food and beverage company. The orders are expected to be installed and revenue earned over the next nine months.

- The company is currently developing energy efficiency projects on a paid or exclusive basis at 15 different sites for 10 different customers. This compares to 7 sites for 3 customers during all of FY 2012 and only 1 site and 1 customer in each of FY 2011 and FY2010.

- The Company's order backlog as at May 31, 2013, was approximately $1.4 million. As at September 16, 2013, the Company had an order backlog of approximately $8.6 million, of which approximately $0.5 million is related to long term contracts and is not expected to be reflected in revenue within the next 12 months. 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 quarterly financial statements.

Summary of Outstanding Shares and Dilutive Instruments

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

Shares

163,336,616 class A common shares.

Options

Number of Options outstanding	Number of Options Exercisable	Exercise Price Per Share $	Expiry Date
2,750,000	2,750,000	0.10	May 4,2015
2,562,500	1,708,333	0.10	May 10, 2016
500,000	166,667	0.10	July 12, 2016
4,820,000	1,606,667	0.10	December 1, 2016
5,360,000	-	0.10	November 22, 2017
15,992,500	6,231,667		

Warrants

There are no warrants outstanding.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The consolidated financial statements of Thermal Energy International Inc. and all the information in this annual financial report have been prepared by management, which is solely responsible for the integrity and fairness of the data presented, including the many amounts, which due to necessity, are based on estimates and judgments. The accounting policies followed in the preparation of these consolidated financial statements conform to Canadian generally accepted accounting principles. When alternative accounting methods exist, management has chosen those that it deems most appropriate in the circumstances. Financial information presented throughout this report is consistent with that in the consolidated financial statements.

Thermal Energy International Inc. 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.

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

Thermal Energy International Inc.'s external auditors, Raymond Chabot Grant Thornton LLP, have conducted an independent audit of the consolidated financial statements in accordance with Canadian generally accepted auditing standards, performing such tests and other procedures as they consider necessary to express an audit opinion. The external auditors have full and unrestricted access to the Audit Committee to discuss their audit and related findings.