FIRST QUARTER REPORT
Period ended August 31, 2013

MANAGEMENT'S DISCUSSION & ANALYSIS

This discussion is dated as of October 28, 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 first quarter of Fiscal Year 2014, ended August 31, 2013. The condensed consolidated interim financial statements and accompanying notes constitute an integral part of the discussion and should be read in conjunction with these comments. During the period ended August 31, 2013, the Company's critical accounting estimates, significant accounting policies and risk factors have remained substantially unchanged. This discussion and analysis of the financial condition and results of operations may contain 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. 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

Revenues and Gross Profits

Revenues were $1,522,123 in the quarter ended August 31, 2013 compared to $862,077 in the quarter ended August 31, 2012. Sales of GEM® Condensate return systems increased by $342,165 (47.5%) over the same period in the previous year to $1,063,003, while sales of heat recovery systems increased by $317,881 (225.1%) to $459,120.

The first quarter of FY 2014 included GEM® Condensate return systems sales of $208,802 in partial fulfillment of an order from a major food manufacturer, as announced July 3, 2013, plus $147,920 from sales to a major hospital, as announced June 13, 2013, with comparative revenue in the first quarter of FY 2013 totaling $60,905 from another major hospital. An increase in other revenue from within the UK and Europe was partially offset by a decrease in revenues within North America, caused by timing of data gathering for orders received.

Heat recovery systems revenue in the first quarter ended August 31, 2013 included $211,726 from the $3.6 million major pulp and paper company order, as announced June 3, 2013, plus $156,552 following completion of a project for a major hospital, as announced December 18, 2012, which was substantially completed in the final quarter of FY 2013. There was no equivalent revenue in the first quarter of the previous year.

The resulting gross profit of $970,012 in the quarter ended August 31, 2013 represented an increase of $445,049, or 84.8%, over the $524,963 achieved in the quarter ended August 31, 2012. These results expressed as a percentage of sales were 63.7% in the first quarter of FY 2014 compared with 60.9% in the first quarter of FY 2013. The increase in gross profit as a percentage of sales is a result of a higher proportion of revenues coming from direct sales of GEM® Condensate return systems.

Expenses

Administration and Selling, Marketing and Business Development expenses in the quarter ended August 31, 2013 totaled $1,285,630 compared with $1,507,917 in the quarter ended August 31, 2012, which included enhanced staff and distributor training events, recruitment costs relating to staff additions, plus audit fees relating to the transition to International Financial Reporting Standards. Other decreases in the current quarter over the same period of the previous year include the allocation of staff costs to research and development and cost of sales, due to increased activity on the ISTP project and heat recovery projects respectively, plus reduced corporate admin expenses following the termination of the agreement with the investor relations firm.

Research and development costs of $69,274 in the first quarter of FY 2014 compared to $nil in the first quarter of FY 2013. Whereas the early part of FY 2013 concentrated on increasing revenues from existing product lines, rather than developing new products, the latter part of the year saw an increase in R&D activity across a number of projects including the ISTP project in China, as announced February 7, 2013. A number of projects are currently ongoing, including the ISTP project and work on developing ancillary products within the GEM® range.

Finance revenue

Finance revenue was $44,425 in the quarter ended August 31, 2013 compared to $11,033 in the quarter ended August 31, 2012. The increase follows the extension of the lease agreement in December 2012 for an additional two years. The interest rate implicit in the lease of 14% is applied against the reducing finance lease receivable balance, hence there will be lower finance revenues as the term of the agreement progresses.

Loss before income taxes for the quarter ended August 31, 2013 was $340,467 compared to a loss of $971,921 in the same quarter of the previous year. The decrease is the result of both increased revenues and reduced administration, selling, marketing and business development expenses.

Income taxes expense for the first quarter of FY 2014 of $18,291 compared to a recovery of $124,594 as reported in the first quarter of FY 2013. Losses made by the Company's wholly owned UK subsidiary Thermal Energy International (UK) Ltd generated a tax credit in the first quarter of FY 2013, whereas the current period saw a profit in the UK entity, thus generating a tax charge for the quarter.

Net loss for the period was $358,758 compared to a loss of $847,327 in the same quarter of the previous year.

Comprehensive loss attributable to Owners of the Parent was $291,456 for the first quarter of FY 2014 compared to $913,232 for the first quarter of FY 2013. A strengthening of the Sterling exchange rate over the Canadian dollar in the first quarter of FY 2014 gave rise to unrealized gains on translating the goodwill and intangible assets acquired as part of the acquisition of the UK subsidiary.

Liquidity & Capital Resources

The working capital was $1,405,067 at August 31, 2013 compared to working capital of $1,552,021 at May 31, 2013 - a decrease of $146,954, while the Company's net cash position (Cash and cash equivalents less Bank loans) decreased by $225,953 from $1,304,395 at May 31, 2013 to $1,078,442 as at August 31, 2013.

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

	Nov 30, 2011 $	Feb 29, 2012 $	May 31, 2012 $	Aug 31, 2012 $	Nov 30, 2012 $	Feb 28, 2013 $	May 31, 2013 $	Aug 31, 2013 $
Current Assets	5,813,077	5,345,538	5,758,086	4,534,637	3,814,265	4,537,306	3,642,680	3,604,594
Current Liabilities	3,500,526	2,942,432	3,190,639	2,800,733	2,770,537	2,761,564	2,090,659	2,199,528
Working Capital	2,312,551	2,403,106	2,567,447	1,733,904	1,043,728	1,775,742	1,552,021	1,405,066

Q1 FY 2014 Changes

Current assets decreased in the current quarter by $38,086 to $3,604,594. The decrease in cash balance of $225,953 was partially offset by an increase in prepayments of $110,591, due mainly to a deposit made to an equipment supplier regarding a heat recovery project. Current liabilities meanwhile increased by $108,869 to $2,199,528. Trade payables decreased by $278,714, due to the settlement in the first quarter of invoices relating to the heat recovery project at a major hospital, and other liabilities decreased by $97,877 mainly due to the settlement of sales tax liabilities outstanding at the end of FY 2013. Offsetting these decreases was an increase in deferred revenue of $488,658, caused by a deposit paid on order by a major hospital of $282,695 plus an increase from the major pulp and paper company of $228,725.

As at August 31, 2013, $74,351 (7.6%) of the Company's trade receivables balance was over 90 days past due but not considered impaired.

Operating cash outflow (defined as net loss for the period, plus items not involving cash, plus lease payments received) for the quarter ended August 31, 2013 was $176,528. After adjusting this for $29,992 of negative changes in non-cash working capital items and foreign exchange adjustments and deducting $20,676 to acquire fixed assets and adding a positive $1,243 to allow for the effect of exchange rate fluctuations on cash and cash equivalents, the net cash outflow was $225,953, decreasing the net cash balance as at August 31, 2013 to $1,078,442 from $1,304,395 as at May 31, 2013.

In addition to its net cash balance of $1,078,442 as at August 31, 2013 the Company also had an estimated $270,000 of unused borrowing capacity under its bank loans.

With cash balances and unused borrowing capacity of approximately $1,348,442, management believes that it has sufficient capital resources to fund existing operations and anticipated capital requirements in the remainder of FY 2014. Order backlog as at August 31, 2013 was approximately $5.5 million compared to $1.9 million at the same time last year. As at October 28, 2013 the Company had $8.7 million in purchase orders that had 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:

	August 31, 2013	May 31, 2013
	$	$
Total estimated minimum lease payments receivable	1,335,160	1,507,952
Less: unearned income	(116,926)	(161,351)
	1,218,234	1,346,601
Less: current portion	(791,323)	(761,404)
	426,911	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	296,709
Residual value of equipment	139,530
	1,335,160

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 August 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 August 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 first quarter ended August 31, 2013 compensation arrangements for directors was as follows:

$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 individual committee chairpersons of the Audit Committee and the Ethics, Governance and Compliance Committee, and $1,000 payable for each in-person meeting.

During the first quarter ended August 31, 2013 Directors fees paid were $22,500. Fees to the Chairperson of the Audit Committee were $1,500; fees paid to the Chairman were $2,250; and a total of $9,000 was paid for in-person meetings.

Compensation paid to directors and officers during the first quarter ended August 31 (inclusive of the amounts described above) was as follows:

	Salaries and fees		**Commissions / incentives**		**Total**	
	2013 $	2012 $	**2013 $**	2012 $	**2013 $**	2012 $
Directors						
M. Williams	**7,250**	8,000	**-**	-	**7,250**	8,000
J. Ansell	**-**	8,000	**-**	-	**-**	8,000
J. Kelly	**8,000**	9,000	**-**	-	**8,000**	9,000
D. Gibbs	**4,750**	6,000	**-**	-	**4,750**	6,000
W. Ollerhead	**5,750**	6,000	**-**	-	**5,750**	6,000
B. Linton	**4,750**	-			**4,750**	-
J. Schoenmakers	**4,750**	-			**4,750**	-
Total	**35,250**	37,000	**-**	-	**35,250**	37,000
Officers						
W. Crossland	**60,000**	60,000	**-**	-	**60,000**	60,000
J. Flynn	**33,034**	31,732	**-**	-	**33,034**	31,732
R. Triebe	**37,305**	33,750	**-**	-	**37,305**	33,750
Total	**130,339**	124,482	**-**	-	**130,339**	124,482

Segmented Information

In the three months ended August 31, 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 by product segment 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 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 three months ended August 31 is 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	**385,179**	321,410	**1,136,944**	540,667	**-**	-	**1,522,123**	862,077
Cost of sales	**(181,330)**	(94,484)	**(370,782)**	(242,630)	**-**	-	**(552,111)**	(337,114)
Gross profit	**203,849**	226,926	**766,163**	298,037	**-**	-	**970,012**	524,963
Amortization of intangible assets	**-**	-	**(8,303)**	(24,646)	**-**	-	**(8,303)**	(24,646)
Other expenses	**(461,936)**	(574,996)	**(595,636)**	(583,230)	**(289,029)**	(325,045)	**(1,346,601)**	(1,483,273)
Finance revenue	**44,425**	11,033	**-**	-	**-**	-	**44,425**	11,033
Profit (loss) before taxation	**(213,662)**	(337,037)	**162,224**	(309,839)	**(289,029)**	(325,045)	**(340,467)**	(971,922)
Taxation	**(2,680)**	-	**(21,633)**	89,803	**6,022**	34,791	**(18,291)**	124,594
Profit (loss) after taxation	**(216,342)**	(337,037)	**140,591**	(220,036)	**(283,007)**	(290,254)	**(358,758)**	(847,328)
Attributable to:								
Owners of the parent	**(226,121)**	(326,957)	**137,807**	(221,188)	**(283,007)**	(290,254)	**(371,321)**	(838,399)
Non-controlling interest	**9,779**	(10,080)	**2,784**	1,152	**-**	-	**(12,563)**	(8,928)

Other expenses within reconciling items comprise the following:

	Quarter ended Aug 31	
	2013	2012
	$	$
Corporate admin costs	**172,945**	199,116
Stock-based compensation	**35,447**	34,393
Professional fees	**69,861**	53,522
Depreciation of property, plant and equipment	**9,420**	10,627
Bank charges and interest	**11,910**	10,306
Foreign exchange differences	**(10,554)**	17,081
Total	**289,029**	325,045

During the quarter ended August 31, 2013 the company had one customer in North America and China that accounted for 14% and two customers within Europe and rest of world that accounted for 14% and 10% of total revenue respectively.

During the quarter ended August 31, 2012 the company had no individual customer that accounted for more than 10% of total revenue for the period.

Further geographical analysis:

	Revenue for the three months ended		Property, Plant and Equipment as at		Goodwill and other Intangible assets as at		Finance Lease Receivable as at	
	August 31, 2013	August 31, 2012	**August 31, 2013**	May 31, 2013	**August 31, 2013**	May 31, 2013	**August 31, 2013**	May 31, 2013
	$	$	**$**	$	**$**	$	**$**	$
Canada	**228,931**	115,636	**36,137**	22,301	**-**	-	**426,911**	585,197
U.S.A.	**135,272**	205,062	**-**	-	**-**	-	**-**	-
U.K.	**928,587**	405,053	**19,346**	23,169	**1,759,710**	1,706,449	**-**	-
Italy	**125,558**	42,534	**-**	-	**-**	-	**-**	-
Netherlands	**6,724**	38,237	**-**	-	**-**	-	**-**	-
Eire	**9,174**	32,357	**-**	-	**-**	-	**-**	-
Rest of Europe	**24,385**	6,485	**-**	-	**-**	-	**-**	-
India	**31,837**	5,538	**-**	-	**-**	-	**-**	-
China	**20,976**	712	**-**	-	**-**	-	**-**	-
Rest of world	**10,679**	10,463	**-**	-	**-**	-	**-**	-
Total	**1,522,123**	862,077	**55,483**	45,470	**1,759,710**	1,706,449	**426,911**	585,197

Material Segmentation Variances

Revenue

North America and China: total revenue for this segment in the quarter ended August 31, 2013 was $385,179, representing an increase of $63,769 over the quarter ended August 31, 2012. A decrease in GEM® revenues of $142,160 was more than offset by an increase in heat recovery revenue of $205,929. The increased heat recovery revenue came from the major pulp and paper company order, as announced June 3, 2013. While GEM® revenues were down, orders received in the first quarter were at a similar level to the same period of the previous year, but were not sufficiently progressed to enable revenue recognition in the quarter.

Europe and Rest of World: total revenue for this segment in the quarter ended August 31, 2013 was $1,136,944, representing an increase of $596,277 over the quarter ended August 31, 2012. Heat recovery revenue increased by $111,952, with one major hospital project reaching completion in the current period, compared with none in the first quarter of the preceding year, although the first quarter of FY 2013 did see $60,019 from the completion of projects for a major food manufacturer. GEM® revenues, meanwhile, increased by $484,325, resulting mainly from partial fulfillment of an order from a major food manufacturer, as announced July 3, 2013, plus an order from a major hospital, as announced June 13, 2013, as well as a general increase in sales across the UK and Italy over the same period of the previous year.

Segment loss before tax:

North America and China gross profit decreased by $23,077 in the quarter ended August 31, 2013 from the same quarter of the preceding year despite an increase in revenue of $63,769, due to the product mix. A decrease in other expenses, including commission payable, recruitment and training, plus an increase of finance revenue over the same quarter of the previous year, served to reduce the loss before tax by $123,375.

Europe and rest of the world produced an income before tax of $162,224 in the quarter ended August 31, 2013, compared to a loss of $309,839 in the quarter ended August 31, 2012. This improvement of $472,063 was the direct result of increased revenues in the region, predominantly from sales of GEM® product, with other expenses remaining at a similar level to the same quarter of the previous year. The first month of FY 2014 saw the complete amortization of other intangible assets (excluding Trade names and Trademarks) which had been capitalized on the acquisition of Gardner Energy Management in July 2008.

Other expenses within Reconciling items, which incorporates all costs not specifically attributable to the either regional operational center, amounted to $289,029 in the first quarter of FY 2014 compared to $325,045 in the first quarter of FY 2013, the reduction being mainly attributable to the expiry in the first quarter of FY 2014 of the twelve month agreement with the investor relations firm, which was not renewed.

Supplementary financial information

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

Quarter ended	31-Aug-13 $	31-May-13 $	28-Feb-13 $	30-Nov-12 $
Revenue	1,522,123	1,879,450	4,208,723	1,259,984
Gross Profit	970,012	746,358	2,906,414	799,717
Gross Profit Percentage	63.7%	39.7%	69.1%	63.5%
EBITDAS(1)	(286,423)	(424,414)	1,573,398	(682,929)
Total net income (loss)	(358,758)	(2,685,427)	1,476,814	(778,011)
Income (loss) per share, basic and diluted	(0.002)	(0.016)	0.009	(0.005)
Net operating cash flow(2)	(176,528)	(223,741)	185,249	(536,159)

Quarter ended	31-Aug-12 $	31-May-12 $	29-Feb-12 $	30-Nov-11 $
Revenue	862,077	3,460,878	3,583,801	4,676,322
Gross Profit	524,963	1,308,407	1,413,265	2,123,687
Gross Profit Percentage	60.9%	37.8%	39.4%	45.4%
EBITDAS(1)	(901,104)	(61,525)	44,242	731,191
Total net income (loss)	(838,399)	(20,941)	(28,913)	459,779
Income (loss) per share, basic and diluted	(0.005)	0.000	0.000	0.003
Net operating cash flow(2)	(668,914)	216,353	236,363	609,587

(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.

Trend Analysis:

The first quarter of FY 2014 saw a decrease in heat recovery revenue from the previous quarter with the completion of the major hospital project which had commenced in the last quarter of FY 2013 and revenue from the major pulp and paper company as announced June 3, 2013 not matching the substantial completion of the three projects in the prior quarter. This decrease of $831,611 was partially offset by an increase in GEM® revenues of $474,283. A decrease in revenues from a major food and beverage manufacturer of $110,139 was more than offset by revenues from another food and beverage manufacturer plus a major hospital. GEM® sales within North America were down from the prior quarter, although orders were received awaiting sizing information, while revenues within Europe more than doubled, mostly within the U.K. and Italy, through directly employed sales personnel. Despite a drop in revenues, gross profit increased by $223,654 as a result of the product mix. Increased commission from increased gross profit plus audit fees billed in the first quarter of the year ate up some of the increased gross profit, resulting in an improvement in EBITDAS of $137,991 from the last quarter of FY 2013.

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 installations at two major food and beverage manufacturers. 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.

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 condensed consolidated interim financial statements for the quarter ended August 31, 2013, these statements were not subject to an audit.

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, produced an operating loss of $844,328, resulting from diminished revenues and increasing costs. The first quarter has also generated a loss but orders received in the quarter which have yet to be revenued indicate that the prior years' investment is starting to pay off. A dip in profitability was expected while new staff additions become accustomed to their roles and the strategy of the Company. Management is constantly monitoring the effectiveness of this strategy.

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 was recorded in the financial statements as an increase to the net investment in lease in the year ended May 31, 2013 which therefore includes the capital element of the total expected payments over the 24 month period of the extension within revenue for that year, totaling $1,546,318. The interest element of the lease will be recorded as finance revenue over the period of the lease, but the cash inflow will include the capital element.

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 Update

- 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 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 system was installed and revenue earned in the first quarter and the heat recovery system is expected to be installed and revenue earned by the third quarter of FY 2014.

- 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 third 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 August 31, 2013 was approximately $5.5 million. As at October XX, 2013, the Company had an order backlog of approximately $8.7 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	333,333	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	6,398,333		

Warrants

There are no warrants outstanding.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The unaudited condensed consolidated interim financial statements of Thermal Energy and all the information in this interim 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 unaudited condensed consolidated interim financial statements conform to IFRS. Financial information presented throughout this report is consistent with that in the unaudited condensed consolidated interim financial statements.

Thermal Energy 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's external auditors, Raymond Chabot Grant Thornton LLP, conducted an independent audit of the consolidated financial statements for the year ended May 31, 2013 in accordance with IFRS, performing such tests and other procedures as they consider necessary to express an audit opinion. The condensed consolidated financial statements for the quarter ended August 31, 2013, prepared in accordance with IFRS, have not been audited.