MANAGEMENT'S DISCUSSION & ANALYSIS – 2012

This discussion is dated as of September 27, 2012 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, 2012 (or FY 2012), and compares the FY 2012 financial results to the previous year ended May 31, 2011 (or FY 2011). 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. 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

Fourth Quarter 2012

Revenues in the fourth quarter 2012 were $3,460,878, compared with $1,913,163 for the same period in 2011, an increase of $1,547,715, or 80.9%. An increase in revenue from heat recovery projects of $2,129,549, of which $1,498,082 was from Fibrek and $723,589 from a major food manufacturer in the UK, was partially offset by a drop in sales of GEM® product of $581,834. The majority of this decrease was as a result of the previous year including sales to the same major food manufacturer in the UK, as announced December 23, 2010 and February 18, 2011, of $558,016, compared to $38,073 in the current period.

The gross profit in the fourth quarter of FY 2012 was $1,308,407 (38%) compared with $1,055,037 (55%) for the same period in 2011, an increase of $253,370, or 24.0%. The reduction in gross profit as a percentage of sales is a result of a higher proportion of revenues coming from heat recovery, which generates lower margins than sales of GEM® Condensate return systems.

Administration and Selling, Marketing and Business Development expenses incurred in the fourth quarter 2012 were $1,471,826, an increase of $222,811 (17.8%) over the $1,249,015 incurred during the same period in 2011. The majority of this increase is the result of additional staff being recruited throughout the current year. A total of five additional sales persons, plus three technical support and one admin role were recruited during FY2012, with the aim of increasing global sales coverage. In addition, loss on foreign exchange was higher as a result of the continued weakening Euro against Sterling.

Finance revenue in the final quarter of FY2012 was $16,915, compared with $66,859 in the same period of the previous year. This is due to the interest rate implicit in the lease of 14% being applied against the reducing finance lease receivable balance, hence lower finance revenues as the term of the agreement progresses.

Net loss for the fourth quarter 2012 was $26,341 compared with $25,142 for the same period in 2011. The tax credit in the fourth quarter of FY2012 was due to the loss incurred in the UK entity during the fourth quarter, thus reducing earlier provisions. In addition, a reduction in the UK tax rate resulted in a further credit of $25,151 relating to the future tax provision against intangible assets.

The Company's net cash position (Cash and cash equivalents less Bank loans) in the fourth quarter decreased by $512,051 while working capital increased by $164,341 from $2,403,106 as at February 29, 2012 to $2,567,447 as at May 31, 2012. The increase in working capital is primarily the result of positive cash flow from operations defined as net loss, plus items not involving cash, plus lease payments received. Cash flow from operations for the quarter was $216,353.

Fiscal Year 2012

Revenues and Gross Profits

Revenues were $13,152,687 in FY 2012 compared to $9,700,596 in FY 2011, an increase of 35.6%. Sales of waste energy recovery systems increased in the year by $4,589,810 (89.6%), while sales of GEM® Condensate return systems decreased by $1,137,719 (24.9%).

Of the $9,713,338 waste energy 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.

FY2011 saw $3,507,419 revenue relating to the contract with Kruger Products announced December 23, 2009. Both years saw two further systems installed in NHS hospitals in the U.K. In addition, two systems installed at a major food manufacturer in the U.K. were substantially completed during FY 2012, providing $723,589 of the $832,000 contracts announced January 30, 2012.

FY 2011 included GEM® Condensate return systems sales resulting from the partial fulfillment of orders from a major food manufacturer, as announced December 23, 2010 and February 18, 2011 totaling $875,941, compared with $307,997 in the current year. Other decreases included $249,338 from a major pharmaceutical company, 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 partially offset by the continuing growth of GEM® sales in North America.

The gross profit of $5,648,371 in FY 2012 represented an increase of $973,753, or 20.8%, on the $$4,674,618 achieved in FY 2011. These results expressed as a percentage of sales were 42.9% in FY 2012 compared with 48.2% in FY 2011. The reduction in gross profit as a percentage of sales is a result of a higher proportion of revenues coming from heat recovery, which generates lower margins than sales of GEM® Condensate return systems.

Expenses

Administration and Selling, Marketing and Business Development expenses in FY 2012 totaled $5,619,590 compared with $4,972,049 in FY 2011, an increase of $647,541, or 13%. The main contributors to this increase include recruitment costs and salaries of the additional roles created during the year, as mentioned above, increased commissions payable on the increased revenues, directors fees relating to the two directors added during the year, audit fees relating to the transition to reporting in accordance with International Financial Reporting Standards, foreign exchange losses due predominantly to the weakening of the Euro against Sterling, the write down of the net investment in lease following a permitted plant shutdown at the site. Legal fees relating to the statement of claim filed against the Company by a past president increased by $14,767 in FY 2012 over the previous year. In addition the Company paid court costs attributed to the former president totaling $36,879. FY 2011, however, included legal fees relating to the TSXV review, which were not repeated in the current year.

Research and development costs increased in FY 2012 to $8,455 compared to $3,837 in FY 2011. In neither year was focus placed on R&D activity, due to the volume of work involved in the heat recovery projects, as well as focus being directed towards increasing sales of existing offerings.

Finance revenue

Finance revenue was $102,956 in FY 2012 compared to $192,007 in FY 2011. 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.

Income / (loss) before income taxes

Resulting income before income taxes for FY 2012 was $123,282 compared to a loss of $109,261 in FY 2011.

Income taxes

Current income taxes for FY 2012 were $38,551, compared to $2,135 in FY 2011. The FY 2012 charge represents taxes payable in the United Kingdom by the Company's wholly owned subsidiary 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. The corresponding charge and credit in the previous year were $110,050 and $107,915 respectively.

Comprehensive income attributable to Owners of the Parent

Comprehensive income attributable to owners of the parent was $87,544 in FY 2012 compared to $85,399 in FY 2011. The strengthening of the Pound Sterling during the previous year served to increase the value of goodwill and intangibles which were acquired in Sterling. During the current year, the exchange rate moved only marginally, hence a much smaller adjustment to comprehensive income in FY 2012.

Liquidity & Capital Resources

The working capital was $2,567,447 at the end of FY 2012 compared to working capital of $1,881,087 at the end of FY 2011 - an increase of $686,360, while the Company's net cash position (Cash and cash equivalents less Bank loans) increased by $399,788 from $972,163 at the end of last year to $1,371,951 as at the end of FY 2012. The strong increases in working capital and net cash have been primarily driven by the Company's positive cash flow from operations (defined as net income, plus items not involving cash, plus lease payments received) which totaled $903,315 for the year.

The Company's steady increase in working capital over all but one of the last eight quarters can be summarized as follows:

	Aug 31, 2010 $	Nov 30, 2010 $	Feb 28, 2011 $	May 31, 2011 $	Aug 31, 2011 $	Nov 30, 2011 $	Feb 29, 2012 $	May 31, 2012 $
Current Assets	3,491,058	3,955,487	3,717,578	3,898,346	4,371,855	5,813,077	5,345,538	5,758,086
Current Liabilities	2,079,385	2,331,863	1,930,687	2,017,259	2,695,481	3,500,526	2,942,432	3,190,639
Working Capital	1,411,673	1,623,624	1,786,891	1,881,087	1,676,374	2,312,551	2,403,106	2,567,447

FY 2012 changes

Current assets increased by $1,859,740 to $5,758,086. This was mainly due to an increase in Cash and short-term investments of $399,788, an increase of $1,522,185 in Accounts Receivable, due mainly to outstanding invoices to Fibrek at May 31, 2012, an additional $107,850 paid as deposits on equipment for future heat recovery projects, tempered by a decrease in the current portion of the Net Investment in Lease of $141,311 as the lease nears its termination date, and other net decreases of $28,772. Current liabilities meanwhile increased by $1,173,380 to $3,190,639. Increases in accounts payable of $457,715, predominantly relating to payments due to subcontractors on the Fibrek project, deferred revenue of $359,357, mainly from customer deposits on future heat recovery projects, and other liabilities of $413,200, including accruals relating to holdbacks and sundry other costs to subcontractors on the Fibrek project and commissions due at year end, were offset by other sundry net decreases of $56,892.

As noted above, cash flow from operations (defined as net loss, plus items not involving cash, plus lease payments received) for the year ended May 31, 2012 totaled $903,315. After adjusting this for negative non-cash equity items and unrealized foreign exchange adjustments totaling $36,561; $427,883 of negative changes in non-cash working capital items; and deducting $41,599 to acquire fixed assets plus $2,516 exchange differences on cash and cash equivalents, the net cash inflow was $399,788, increasing the net cash balance as at May 31, 2012 to $1,371,951 from $972,163 as at May 31, 2011.

In addition to its net cash balance of $1,371,951 as at May 31, 2012 the Company also had an estimated $241,000 of unused borrowing capacity under its bank loans.

With cash balances and unused borrowing capacity of approximately $1,612,951, management believes that it has sufficient capital resources to fund existing operations and anticipated capital requirements in FY 2013.

Net Investment in Lease

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

	May 31, 2012 $	May 31, 2011 $
Total estimated minimum lease payments receivable	530,779	1,215,814
Less: unearned income	(18,283)	(94,484)
	512,496	1,121,330
Less: current portion	(512,496)	(653,807)
	-	467,523

The estimated minimum lease payments receivable in this lease represent the estimated monthly energy outputs of the leased asset and are based on assumptions regarding the efficiency of the asset, the operations of the plant in which it is located and penalty payments resulting from temporary plant shut-downs. The lease expires December 31, 2012, at which time the customer has the option to purchase the asset for $1,000,000 or extend the lease term for a further 24 months with a 15% reduction in the purchase price of the asset to $850,000 at the end of the extended term.

In the quarter ended November 30, 2011, the customer took advantage of a clause within the agreement allowing for a shutdown of a maximum of 45 days without penalty. The effect of this shutdown during the winter period was to decrease the value of the finance lease receivable by approximately $92,539. This write off was partially offset by an increase of $37,781 due to the lease commencing one month earlier than originally anticipated. The net result of these two issues was a write-down in the finance lease receivable at the end of November 2011 of $54,758. There are no further allowances available within the lease agreement for shutdowns without penalty.

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:

	$
FY 2013	391,249
Residual value of equipment	139,530
	530,779

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.

Dry-Rex™ Agreement

During the year, the Company amended and extended its licensing and patent purchase agreement with Mabarex Inc. related to the Dry-Rex™ technology. In exchange for minimum annual royalty payments of $5,000 the agreement provides the Company with a sole and exclusive worldwide license to the Dry-Rex™ technology. The agreement also provides the Company the option to purchase the Dry-Rex™ technology at any time during the term of the agreement.

Related Party Transactions

In FY 2012 Directors were paid fees for services of $146,419. No fees were paid to Officers.

Options outstanding for Directors as at May 31, 2012 (excluding the CEO) were 1,250,000, none of which were exercisable. There were no warrants outstanding for Directors.

Options outstanding for Officers as at May 31, 2012 (including the CEO) were 4,140,000 of which 1,900,083 were exercisable. There were no warrants outstanding for Officers.

There were no loans outstanding to shareholders, to enable the exercise of options and purchase of shares, at May 31, 2012.

Chinese Joint Venture

In 2007, the Company entered into a joint venture agreement with two partners under the laws of the Peoples Republic of China to establish a new company with the name of Thermal Energy International (Guangzhou) Ltd ("TEIG"). The Company owned a 55% interest of the joint venture, a Chinese based operating partner owned 40% and a Chinese consultant that assisted with the Company's activities in China owned 5%. The joint venture was set up to market, sell and install Thermal Energy International Inc.'s suite of products in China. The start-up capital required was $200,000 CDN and each partner contributed their respective share during the year ended May 31, 2009.

Initially, the management of TEIG was conducted by the Chinese based operating partner, with minimum input from the Company who had one board member out of a total of three. As a result, the financial results of TEIG were included in the consolidated financial statements of the Company on a proportionate share basis. That is, 55% of the operating results plus 55% of all assets and liabilities of the TEIG were included on a line by line basis in the consolidated financial statements of the Company. On September 6, 2010 however, the Chinese based operating partner resigned from management of the joint venture and as a board member and Thermal Energy added a board member. The retiring Director agreed to hand over the company seals and bank control to Thermal Energy. Thermal Energy International Inc assumed management control of TEIG. It was consequently determined that, from Q2 2011 onwards, the results of TEIG should be included in the group financial statements on a consolidated basis, i.e. 100% of the operating results plus 100% of all assets and liabilities of the joint venture to be included on a line by line basis in the consolidated financial statements of the Company with the 45% minority interest recorded accordingly.

The reported consolidated financial statements of the Company for the year ended May 31, 2011 therefore include the first quarter ended August 31, 2010 on a proportionate basis with the quarters ended November 30, 2010, February 28, 2011 and May 31, 2011 being included on a full consolidation basis.

There are no significant differences in the accounting policies of the Chinese entity and the Company.

The results of the joint venture for the first quarter of FY 2011, as included in the consolidated financial statements of Thermal Energy International Inc. are as follows:

	Quarter ended Aug 31, 2010 $	Year ended May 31,2010 $
Current Assets	**122,235**	130,410
Current Liabilities	**109,056**	98,684
Sales	**1,419**	109,569
Cost of sales	**(2,705)**	(105,446)
Other expenses	**(19,112)**	23,241
Net profit (loss)	**(20,398)**	25,874
Cash flows provided (used in) operating activities	**1,272**	(36,622)
Cash flows used in investing activities		(2,520)

The above figures represent the Company's 55% share in the joint venture.

The results of the Chinese entity for the remaining three quarters of FY 2011 are fully consolidated within the financial statements of Thermal Energy International Inc. The impact of the change to full consolidation from the second quarter of FY 2011 onwards for the year ended May 31, 2011 was as follows:

	Proportionate consolidation @ **55% $**	**As reported $**	Difference $
Total Assets	**39,848**	**72,450**	32,602
Current Liabilities	**(2,502)**	**(4,548)**	(2,046)
Non-controlling interest	**-**	**(30,556)**	(30,556)
Net difference to balance sheet			-

	Proportionate consolidation @ 55% $	As reported $	Difference $
Sales	**19,857**	**34,922**	15,065
Cost of sales	**(13,137)**	**(21,633)**	(8,496)
Other expenses	**(2,916)**	**9,441**	12,357
Non-controlling interest		**(18,926)**	(18,926)
Net profit	**3,804**	**3,804**	-

Sales in China through TEI (Guangzhou) Ltd came to a virtual halt during the last three quarters of FY 2011, pending resolution of management and staffing changes. Expenses incurred were related to the maintenance of the office plus technical and selling and administrative staff. Management has now established a stable team to recommence the distribution of the Company's range of products in China. There was no revenue from the Chinese operation in any quarter of FY 2012, with expenses relating to office rental and three employees of $22,645 in the quarter ended August 31, 2011, a net loss in the quarter ended November 2011 of $7,402, representing costs of $10,728 less the recovery of a previously written off bad debt of $3,326, plus a net loss in the third quarter ended February 29, 2012 of $15,578, predominantly all staff related costs. The final quarter ended May 31, 2012 had net costs of $11,412.

Segmented Information

In fiscal 2012 and 2011, 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. Segmented information was previously reported on a product line basis, rather than the geographical basis set out below. As a result, the Company has restated the corresponding items of segment information for the previous year.

Segment information for the year ended May 31, 2012 and the comparative year are detailed in the table below.

	North America and China		Europe and Rest of World		Reconciling items		Total	
	2012	2011	**2012**	2011	**2012**	2011	**2012**	2011
	$	$	**$**	$	**$**	$	**$**	$
Total revenue	**7,235,139**	4,888,103	**5,917,548**	4,812,493	**-**	-	**13,152,687**	9,700,596
Cost of sales	**5,095,752**	3,388,028	**2,408,564**	1,637,950	**-**	-	**7,504,316**	5,025,978
Gross profit	**2,139,387**	1,500,075	**3,508,984**	3,174,543	**-**	-	**5,648,371**	4,674,618
Amortization of intangible assets	**-**	-	**(99,126)**	(103,246)	**-**	-	**(99,126)**	(103,246)
Other expenses	**(1,738,315)**	(1,405,214)	**(2,323,389)**	(2,165,802)	**(1,467,215)**	(1,301,624)	**(5,528,919)**	(4,872,640)
Finance revenue	**102,956**	192,007	**-**	-	**-**	-	**102,956**	192,007
Profit (loss) before taxation	**504,028**	286,868	**1,086,469**	905,495	**(1,467,215)**	(1,301,624)	**123,282**	(109,261)
Taxation	**-**	-	**(174,337)**	(171,169)	**135,786**	169,034	**(38,551)**	(2,135)
Profit (loss) after taxation	**504,028**	286,868	**912,132**	734,326	**(1,331,429)**	(1,132,590)	**84,731**	(111,396)
Attributable to:								
Owners of the parent	**529,695**	267,942	**903,163**	722,066	**(1,331,429)**	(1,132,590)	**101,429**	(142,582)
Non-controlling interest	**(25,667)**	18,926	**8,969**	12,260	**-**	-	**(16,698)**	31,186

Reconciling items comprise the following:

	Year ended May 31	
	2012	2011
	$	$
Corporate admin costs	**873,650**	850,256
Stock-based compensation	**123,105**	62,631
Professional fees	**324,496**	286,935
Depreciation of property, plant and equipment	**45,851**	50,022
Bank charges and interest	**43,304**	38,017
Foreign exchange differences	**56,809**	13,763
Total	**1,467,215**	1,301,624

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 Rest of World that accounted for 16% of total revenue for the year.

During the year ended May 31, 2011, the Company had one customer in North America and China that accounted for 37% of total revenue for the year.

Further geographical analysis:

	Revenue		Property, Plant and Equipment		Goodwill and Intangible assets		Finance Lease Receivable	
	2012	2011	**2012**	2011	**2012**	2011	**2012**	2011
	$	$	**$**	$	**$**	$	**$**	$
Canada	**6,042,926**	4,122,542	**28,448**	20,115	**-**	-	**512,496**	1,121,330
U.S.A.	**1,130,002**	433,168	**-**	-	**-**	-	**-**	-
U.K.	**4,934,749**	3,372,231	**40,512**	51,824	**4,145,745**	4,258,567	**-**	-
Italy	**541,255**	457,669	**-**	-	**-**	-	**-**	-
Netherlands	**116,665**	96,548	**-**	-	**-**	-	**-**	-
Eire	**77,857**	108,786	**-**	-	**-**	-	**-**	-
Germany	**31,809**	159,894	**-**	-	**-**	-	**-**	-
Rest of Europe	**31,999**	179,468	**-**	-	**-**	-	**-**	-
Singapore	**63,316**	5,456	**-**	-	**-**	-	**-**	-
China	**62,211**	332,393	**1,364**	2,588	**-**	-	**-**	-
Pakistan	**19,427**	105,136	**-**	-	**-**	-	**-**	-
Turkey	**6,647**	108,848	**-**	-	**-**	-	**-**	-
Malaysia	**4,484**	159,445	**-**	-	**-**	-	**-**	-
Rest of world	**89,340**	59,012	**-**	-	**-**	-	**-**	-
Total	**13,152,687**	9,700,596	**70,324**	74,527	**4,145,745**	4,258,567	**512,496**	1,121,330

Material Segmentation Variances

Revenue

North America and China: total revenue for this segment in FY 2012 was \$7,235,139, representing an increase of \$2,347,036 over the prior year. Of this increase, \$2,099,520 related to the increased heat recovery revenue from Fibrek over the Kruger contract from FY 2011. GEM® revenues increased by \$247,516 in the year ended May 31, 2012 over the previous year due to one extra fully effective salesperson in North America.

Europe and Rest of World: total revenue in FY 2012 for this segment was \$5,917,548, compared with \$4,812,493 in FY 2011. An increase in heat recovery revenue of \$2,490,290 was mainly due to the St. George's NHS Trust project plus projects at two sites of a major UK food manufacturer. GEM® revenues, however, decreased by \$1,385,235, due in part by the reduced revenues from orders received from the major food manufacturer in the previous year, reduced revenues from the major pharmaceutical company with whom a key supplier agreement was signed in 2008, 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 \$504,028 in FY 2012, an increase of \$279,791 over the preceding year. This was predominantly a result of the increased gross profit resulting from the Fibrek project, however costs also increased mainly from the addition of staff plus increased training of distributors in North America. Finance revenue was down by \$89,051 from the previous year, due to interest being earned on a reducing balance basis.

Europe and rest of the world income before tax increased by \$180,974 in the year ended May 31, 2012 over the previous year. Although gross profit increased by \$334,441, an increase in other expenses of \$157,587 brought the overall net income increase down. Additional other expenses in FY 2012 came from an increase in staff numbers.

Other expenses within Reconciling items, which incorporates all costs not specifically attributable to the either regional operational center, increased in FY 2012 over the previous twelve month period by \$228,222. This increase was due to the two directors added during the year, audit costs relating to the conversion to IFRS reporting, and foreign exchange differences, as well as other sundry cost increases.

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, 2010, 2011 and 2012

	2010 $	2011 $	2012 $
Revenue	5,812,655	9,700,596	13,152,687
Gross Profit	3,557,307	4,674,618	5,648,371
Gross Profit Percentage	61.2%	48.2%	42.9%
EBITDAS[(1)]	(2,491,306)	110,080	449,142
Total net income (loss) attributable to owners of the parent	(3,071,851)	(142,582)	101,429
Net profit (loss) per share – basic and diluted	(0.019)	(0.001)	0.001
Total assets	8,695,269	8,698,963	9,974,155
Total long term financial liabilities	0	0	0
Cash dividends declared per share	0.00	0.00	0.00
Net operating cash flow[(2)]	(2,569,413)	587,516	903,315

(1) EBITDAS represents earnings before interest, taxation, depreciation, amortization, 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.

In FY 2010, net loss attributable to owners of the parent was $3,071,851 against revenue of $5,812,625. A number of write offs and provisions totaling $963,213 contributed to this loss, including an accounts receivable balance owing from the joint venture in China ($296,433), the potential liability pursuant to a claim and counter claim from a former President of the Company ($190,000), a potentially unrecoverable debt relating to a previous heat recovery project ($103,400), the write off of the accounts receivable balance of Fraser Papers Inc, after it filed for protection from its creditors under the Companies' Creditors Arrangement Act ($180,000), plus the write down of the Net Investment in Lease subsequent to the signing of a new 30 month agreement with Fortress Paper ($193,380).

FY 2010 saw the assets value drop simply due to losses experienced in the year.

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.

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.

Quarterly financial information (unaudited)
For the eight quarters ended May 31, 2012

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

Quarter ended	31-Aug-10 $	30-Nov-10 $	28-Feb-11 $	31-May-11 $
Revenue	2,985,667	2,938,131	1,863,635	1,913,163
Gross Profit	1,203,660	1,275,844	1,140,077	1,055,037
Gross Profit Percentage	40.3%	43.4%	61.2%	55.1%
EBITDAS(1)	64,826	46,178	78,638	(79,562)
Total net income (loss)	(34,760)	(3,186)	(53,842)	(50,794)
Income (loss) per share, basic and diluted	0.000	0.000	0.000	0.000
Net operating cash flow(2)	149,209	183,724	167,807	86,776

(3) EBITDAS represents earnings before interest, taxation, depreciation, amortization, share-based compensation expense and net write down of lease.
(4) Net operating cash flow represents net income (loss) plus items not involving cash, plus lease payments received.

Trend Analysis:

The first quarter of Fiscal Year 2011 produced revenues of $2,985,667 and a net loss of $34,760. The increase in revenues over the previous quarter came mainly from heat recovery products, which increased gross profit by $328,641 over the previous quarter. The majority of the revenue from heat recovery systems sales was generated from the Kruger Products contract at $1,827,267, with $296,689 coming from the partial recognition of a project at Kings College hospital in London for the installation of a waste heat recovery solution. Total revenue from heat recovery projects for the quarter was $2,200,760. GEM® product sales were $784,907, with no particularly large individual orders, but with $52,388 coming in from a new distributor in China. Continuing cost management ensured expenses were kept low, thus resulting in a relatively small loss in the quarter.

Q2 Fiscal Year 2011 produced revenues on a similar scale to Q1. With a higher level of GEM® sales than the prior quarter, gross profit was increased. Revenue from heat recovery systems for the quarter was $1,890,302, of which $1,614,754 related to the Kruger contract and $186,818 from the project at Kings College Hospital. GEM® product sales increased up to $1,047,829 for the quarter, due partly to sales to the major pharmaceutical company of $306,892. This higher level of sales combined with continued cost management generated a net loss of $3,186, an improvement of $31,574 over the first quarter.

Total sales in Q3 2011 of $1,863,635 were lower than the previous two quarters due to the stage of completion of the Kruger project, which generated $57,220 in the quarter. The installation of a heat recovery system at the Royal National Orthopaedic Hospital (RNOH) contributed $397,678 towards the total heat recovery systems sales of $607,056. Sales of GEM® products in the third quarter were $1,256,579, of which $317,925 related to orders received from a major food manufacturer in the UK, as announced December 23, 2010, and $87,810 from another hospital within the NHS in the UK. Resulting net loss for the quarter was $53,842, due in part to the provision for taxes generated from profits made in the UK entity of $100,156.

Q4 Fiscal Year 2011 saw revenues at a level similar to the previous quarter. Sales of GEM® product were higher at $1,487,753, of which $558,016 related to the major food manufacturer in the UK and $220,448 related to sales within the NHS in the UK. At $425,410, revenues from heat recovery systems were less than Q3 which, as stated above, included the majority of the RNOH project. At $50,794, the net loss for the fourth quarter was a slight improvement on Q3, due mainly to the recovery of future taxes relating to intangible assets, which cancelled the effect of higher costs on a smaller heat recovery project plus higher cost of sales on GEM® product due to more revenue coming from installation of traps in the quarter, which attract a lower margin that the product itself.

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 November 30, 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 November 30, 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 Qincunbao 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.

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 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.

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.

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 financial statements ended May 31, 2012, 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:

The management of the Company realizes that the operating losses in FY 2010, display a consistent pattern of losses as in previous years. However as noted above the operating losses in FY 2010 were partly attributed to $963,213 in one-time provisions and write-offs. FY 2011 also resulted in a loss, however this was much reduced from previous years' losses due to achieving a larger number of both waste energy recovery projects and GEM sales, along with improved cost controls. FY 2012 has seen the Company's first ever net profit, which is a result of increased revenues and strict cost control.

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 is 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 waste energy expected to be recovered, this agreement was expected to provide the Company approximately $720,000 of additional cash flow per year between now and December 31, 2012. To date, it has delivered just that. It is anticipated that the agreement may be extended for a number of months beyond December 31, 2012, while a decision is made regarding the termination or contractual extension 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 Update:

1. On December 23, 2010 and February 18, 2011 the Company announced it had received purchase orders totalling approximately $1.3 million from a major food manufacturer based in the UK, to provide GEM® condensate return systems for use at twelve of its manufacturing sites. Sales for the year ending May 31, 2011 included approximately $0.9 million related to these orders with a further $0.3 million earned in fiscal 2012.

2. On April 11, 2011 the Company announced it had received a purchase order for approximately £246 thousand (approximately CDN $386 thousand) from Salisbury District Hospital Trust, a major hospital in South West England, to install a heat recovery system for use on its heating and hot water system. This system was largely completed in the first quarter of fiscal 2012.

3. On May 6, 2011 the Company received a purchase order for approximately £208 thousand (approximately $334 thousand) from Frimley Park Hospital NHS Trust in the UK to provide to provide GEM® condensate return products and a heat recovery solution for use on its heating and hot water system. This project was completed within the first half of this fiscal year.

4. On June 16, 2011 the Company announced it had signed a contract valued at approximately $5.8 million with Fibrek to provide a heat recovery solution for its pulp mill located in Saint-Félicien, Québec. This project was substantially completed this fiscal year.

5. On July 21, 2011 the Company received a purchase order for approximately $340 thousand from a major multi-national bakery company to provide a heat recovery solution for one of its United States based manufacturing facilities. This project was completed over this fiscal year.

6. On August 5, 2011 the Company announced it had received a purchase order for approximately £1.29 million (approximately CDN $2.06 million) from St Georges Healthcare NHS Trust, a major hospital in London, UK to provide a heat recovery solution for use on its heating and hot water system. This project was completed this fiscal year.

7. On August 31, 2011 the Company amended and extended its distributor, licensing and patent purchase agreement with Mabarex Inc. related to the Dry-Rex™ technology. In exchange for minimum annual royalty payments of approximately $5,000, the agreement provides the Company with a sole and exclusive worldwide licence to the Dry-Rex™ technology for the next 10 years. The agreement also provides the Company the option to purchase the Dry-Rex™ technology at any time during the term of the agreement.

8. On January 4 and January 6, 2012, the Company received orders from a major food manufacturer in the U.K. for heat recovery solutions at two of its sites. The orders total approximately $832,000 and were substantially completed this fiscal year.

9. On April 20, 2012, the Company received an order for the value of £316,844 (approximately $500,000) from St. Bartholomew's Hospital in the UK for its heat recovery solutions. This order is expected to be substantially completed in the second quarter of FY 2013.

10. On May 10, 2012, the Company announced it had received a further purchase order for approximately $467 thousand from the major food manufacturer in the U.K. for a heat recovery solution. This order is expected to be completed in FY 2013.

11. The Company's order backlog as at May 31, 2012 was approximately $1.4 million. As at September 27, 2012 the Company had approximately $2.9 million in purchase orders that had not yet been reflected as revenue in the Company's published quarterly financial statements.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

In February 2008, the Canadian Institute of Chartered Accountants (CICA) announced that Canadian GAAP for publicly accountable enterprises would be replaced by IFRS for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The standard also requires that comparative figures for 2010 be based on IFRS. Accordingly, the Company has adopted IFRS on June 1, 2011, with restatement for comparative purposes of amounts reported by the Company for the fiscal year beginning June 1, 2010. The audited condensed consolidated financial statements for the year ended May 31, 2012, which should be read in conjunction with this discussion, have been prepared in accordance with International Financial Reporting Standards.

The significant accounting policies adopted under IFRS are included in note 2 to the consolidated financial statements for the year ended May 31, 2012. These accounting policies have been applied consistently to all periods presented in the financial statements. They also have been applied in preparing an opening IFRS statement of financial position as at June 1, 2010, the Company's transition date, as required by IFRS 1. The accounting policies have been selected to be consistent with IFRS as effective on May 31, 2012, the Company's first annual

IFRS reporting date. Reconciliations and descriptions of the effect of the transition from Canadian GAAP to IFRS are included in note 28 to the consolidated financial statements for the year ended May 31, 2012.

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	2,166,667	0.10	May 4,2015
2,562,500	854,167	0.10	May 10, 2016
500,000	166,667	0.10	July 12, 2016
5,190,000	-	0.10	December 1, 2016
11,002,500	3,187,501		

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.