



THIRD QUARTER REPORT Period Ended February 28, 2010

MANAGEMENT DISCUSSION AND ANALYSIS

The following discussion explains material changes in the Corporation's financial condition and results of operations for the third quarter of Fiscal Year 2010, ended February 28, 2010. The quarterly financial statements constitute an integral part of the discussion and should be read in conjunction with these comments.

Description of Business

Thermal Energy International Inc. ("Thermal Energy" or the "Company"), 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's products include:

GEM® - Steam traps and condensate return systems

FLU-ACE® - Direct contact condensing heat recovery

Dry Rex™ - Low temperature biomass drying systems

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 GHG 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

Revenue and Gross Profit

Total sales for the third quarter ended February 28, 2010 were \$1,306,548, an increase of 91% compared with \$682,341 in 2009. Sales of GEM™ Condensate return systems for the third quarter ended February 28, 2010 were \$1,052,222, an increase of 65% compared with the same period in 2009. Sales of waste energy recovery systems for the third quarter ended February 28, 2010 were \$254,326, an increase of 471% compared with the same



period in 2009. Sales of waste energy recovery systems to Kruger Products Limited, pursuant to the contract with Kruger Products announced December 23, 2009, for the third quarter ended February 28, 2010 were \$155,024.

For the nine months ended February 28, 2010 total sales were \$4,176,011, up 45% compared to \$2,881,222 in Fiscal Year 2009. Sales of GEM™ Condensate return systems for the nine months ended February 28, 2010 were \$3,448,936, an increase of 50% compared with the same period in 2009. Sales of waste energy recovery systems for the nine months ended February 28, 2010 were \$727,075, an increase of 25% compared with the same period in 2009.

Gross profit for the third quarter ended February 28, 2010 was \$812,322 (62%) up \$516,649 or 175% compared with \$295,673 (43%) in 2009. The lower margin in 2009 was caused by cost overruns on a waste energy recovery project.

For the nine months ended February 28, 2010 gross profit was \$2,682,288 (64%), up \$1,035,649 or 62% compared to \$1,646,639 (57%) from the same period in 2009.

Expenses

Administration and Selling, Marketing and Business Development expenses in the third quarter ended February 28, 2010 totalled \$1,196,123, a decrease of \$254,261 or 18% from the \$1,450,384 incurred in 2009. This decrease was due partly to a bad debt of \$125,000 written off in the previous year, plus cost cutting measures that the Company undertook this year.

During the third quarter ended February 28, 2010, the Company incurred non-recurring Administration and Selling, Marketing and Business Development expenses of approximately \$187,000. Non-recurring costs in the quarter consist of expenses that have been eliminated going forward as a result of cost cutting measures implemented this year. Excluding these non-recurring costs, Administration and Selling, Marketing and Business Development expenses in the quarter were \$1,009,123, a decrease of \$441,261 from last year.

For the nine months ended February 28, 2010 Administration and Selling, Marketing and Business Development expenses totalled \$4,007,924, an increase of \$33,490 from the same period last year. However, Administration and Selling, Marketing and Business Development expenses for the nine months ended February 28, 2010 included approximately \$1,016,000 of non-recurring costs consisting of \$370,000 of non-cash provisions taken in the second quarter of this fiscal year and \$646,000 of expenses that have been eliminated going forward as a result of cost cutting measures implemented this year. Excluding these non-recurring costs, Administration and Selling, Marketing and Business Development expenses for the nine months ended February 28, 2010 were \$2,991,924, a decrease of \$982,510 from the same period last year.



Legal fees in the third quarter ended February 28, 2010 were \$77,911, compared with \$15,034 in 2009. However \$67,605 of legal fees incurred were non-recurring expenses related to the TSX Venture Exchange review, the claim and counter claim from a former President of the company, and the settlement of a claim from a former officer of the company.

Legal fees for the nine months ended February 28, 2010 were \$200,823, compared with \$84,416 in 2009. However \$175,768 of legal fees incurred in the nine months ended February 28, 2010 were non-recurring expenses related to the TSX Venture Exchange review, the claim and counter claim from a former President of the company, and the settlement of a claim from a former officer of the company.

Audit fee expense in the third quarter ended February 28, 2010 was \$4,761 a decrease of \$16,900, compared to \$21,661 incurred in 2009. The 2009 expense represented accrued costs for that year to date, however recent changes in the accounting rules now require reporting of the auditing expense upon receipt of the auditors invoice and not accrued as was the process followed in the past. The 2009 expense relates to the audit of the Fiscal Year 2009 financial statements which are higher than last year because the Fiscal Year 2009 audit includes a consolidation of Gardner Energy Management Ltd. and Thermal Energy International (Guangzhou) Ltd. and also required a valuation of intangible assets and goodwill as at May 31, 2009.

Insurance costs in the third quarter ended February 28, 2010 were \$39,010 an increase of \$5,595 compared to \$33,415 in 2009.

Amortization of property, plant and equipment was at \$16,307 in the third quarter ended February 28, 2010 compared with \$11,857 in 2009.

Amortization of intangible assets was \$46,625 in the third quarter ended February 28, 2010. The intangible assets were acquired with the purchase of GEM and amortization was first recognised in the Fiscal Year 2009 year-end financial statements.

Patent and Trademark maintenance costs were \$nil in the third quarter ended February 28, 2010, compared to \$630 in 2009. All Patent and Trademark costs incurred by the Company are expensed as incurred.

Research and Development costs were \$10,707 in the third quarter ended February 28, 2010, compared to \$30,019 in 2009. The decrease was due to the cessation of testing of



biomass material pertaining to the development of potential DRY-REX projects at the end of December 2009.

Interest and bank charges were \$16,178 in the third quarter ended February 28, 2010 compared with \$17,844 in 2009.

Foreign exchange loss on monetary assets and liabilities in the third quarter ended February 28, 2010 was \$32,427 compared with a gain of \$33,244 in 2009.

Interest revenue of \$3 in the quarter ended February 28, 2010 compared with \$11,569 in 2009. Declining interest rates and a lower level of short-term investments were the reason.

Finance revenue was \$nil in the third quarter ended February 28, 2010 from the THERMAL-AUD™ financed project, compared to \$63,865 in 2009. Invoicing pursuant to the THERMAL-AUD™ financed project was suspended in October 2009, as the customer has filed for protection from its creditors under the Companies' Creditors Arrangement Act.

Loss before income taxes and non-controlling interest for the third quarter ended February 28, 2010 was \$627,724, an improvement of \$548,769 from the same period last year. However excluding the non-recurring Administration and Selling, Marketing and Business Development expenses, and the non-recurring legal fees discussed above, Loss before income taxes and non-controlling interest for the third quarter ended February 28, 2010 was \$373,119, an improvement of \$803,374 from the same period last year.

For the nine months ended February 28, 2010 the loss before income taxes and non-controlling interest was \$2,085,230, an improvement of \$538,262 from the same period last year. However excluding the non-recurring Administration and Selling, Marketing and Business Development expenses and the non-recurring legal fees discussed above, the Loss before income taxes and non-controlling interest for the nine months ended February 28, 2010 was \$893,462, an improvement of \$1,730,030 from the same period last year.

Provision for income taxes must be calculated for each Company within the Thermal Energy Group, in accordance with local tax legislation. The provision for the year to date relates to taxes against profits attributable to Gardner Energy Management Limited, based in the UK.



Net Loss was \$646,842 in the third quarter ended February 28, 2010 compared to a net loss of \$1,181,735 in 2009. Management continues to work hard to control overhead costs but its main focus at the present time is to leverage the sales of its proprietary technologies worldwide in a cost effective manner by continuing to develop a number of strategic alliances, cooperative partnerships, synergistic sales agencies and agreements with companies in all of its key markets.

Liquidity and Solvency

At February 28, 2010, the Company had working capital of \$1,475,398 compared to working capital of \$3,791,332 at May 31, 2009. The \$2,315,934 decrease in working capital is accounted for by a \$2,127,104 decrease in net cash (Cash and cash equivalents less Bank loans) and a \$188,830 decrease in non-cash working capital (working capital excluding Cash and cash equivalents and Bank loans). Non-cash current assets increased by \$45,727, due mainly to a \$315,258 increase in accounts receivable, which was countered by a reduction in inventories of \$170,894. Non-cash current liabilities increased by \$234,557. The major changes include a decrease in accounts payable of \$320,394, an increase in accrued liabilities of \$216,669 and an increase in deferred revenue of \$338,282. The large increase in accrued liabilities includes an increase in taxation payable for the UK entity of \$93,431 and provisions for potential liabilities with former employees totalling \$262,500. Offsetting these increases was a decrease in GEM earn-outs payable of \$247,960.

For the quarter ending February 28, 2010 the Company's net cash (Cash and cash equivalents less Bank loans) position decreased by \$401,560 to \$569,321.

Management continues to recognize the requirement to maintain liquidity in order to continue as a going concern, and as a result is aggressively working to increase sales, reduce costs and manage working capital.

Related Party Transactions

As at February 28, 2010, loans to Directors and Officers to exercise options and acquire shares were \$65,000 (\$527,447 as at May 31, 2009) and to Shareholders \$350,547 (\$299,904 as at May 31, 2009). Accrued interest on these loans stood at \$4,858 on loans to Directors and Officers as at February 28, 2010 (\$38,652 as at May 31, 2009) and \$41,594 on loans to Shareholders (\$22,038 as at May 31, 2009)



SEGMENTED INFORMATION

In the quarters ended February 28, 2010 and 2009 the Company operated in the energy conservation and environmental compliance (air) industry in North America and Europe and was also engaged in the start-up phase of similar operations in China. Within this business segment, the Corporation markets, sells, engineers, fabricates, constructs, installs and supports two product lines – waste energy recovery solutions and condensate return system solutions. Assets are located in Canada, Europe and China.

The Company operates in three reportable segments, waste energy recovery systems, condensate return systems (GEM™), and Thermal-AUD™ financed projects whereby the Company finances the sale and installation of the product at the customer's facility and then leases the product back to the customer. These three reportable segments are detailed below:

	Waste Energy		Thermal -AUD™		GEM™	
	Quarter ended Feb 28		Quarter ended Feb 28		Quarter ended Feb 28	
	2010	2009	2010	2009	2010	2009
	\$	\$	\$	\$	\$	\$
Revenue from external customers	254,326	44,531	-	-	1,052,222	637,810
Inter-segment revenues	-	28,667	-	-	111,010	7,086
Segment loss (profit)	546,667	1,107,281	991	(27,424)	99,184	101,878
Total assets	3,499,070	6,390,307	1,912,444	2,074,024	7,325,999	6,939,755

	Quarter ended Feb 28	Quarter ended Feb 28
	2010	2009
Reconciliation of loss to financial statements		
Total loss for reported segments	\$646,842	\$1,181,735

The following table shows selected consolidated financial data for the most recent eight quarters. The quarterly information has been prepared on the same basis as the consolidated financial statements.



Quarterly financial information (unaudited)

For the eight quarters ended February 28, 2010

	2008	2009				2010		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Sales	2,750,487	1,058,318	1,140,563	682,341	1,077,700	1,304,936	1,564,527	1,306,548
Net Loss	521,388	616,086	834,331	1,181,735	573,225	570,530	830,630	646,842
Net loss per share basic and diluted	0.005	0.004	0.005	0.007	0.003	0.003	0.005	0.004

Trend Analysis:

Q4 2008 saw losses of \$521,388. This level of losses was consistent with previous quarters, but was based on a higher level of revenue. Revenue of \$2,750,487 included the recognition of the Fraser Papers Canada Thurso mill sale. Although this sale generated a profit, losses were suffered on the Philips project, resulting in a gross profit of just 13%. In addition, legal costs of \$262k relating to the purchase of GEM and litigation with the former CEO inflated SGA costs.

The losses in Q1 Fiscal Year 2009 increased to \$616,086. Gross margins were much improved but were more than offset by increases in the major areas of administration and sales and marketing and increases in R&D expenditures for equipment related to testing the THERMALONOX® technology. Expenses were impacted on a comparative basis by the acquisition of GEM on 1st July 2009.

The losses in Q2 Fiscal Year 2009 increased to \$834,331. Gross margins were improved from the previous quarter but were more than offset by increases in the major areas of administration and sales and marketing and increases in R&D expenditures related to testing the THERMALONOX® technology in China. Expenses were impacted to a greater degree from the first quarter on a comparative basis by the acquisition of GEM.

Q3 Fiscal Year 2009 illustrated the impact of the global recession, with revenue down significantly on prior quarters. As a result, despite cost reductions elsewhere, losses increased to \$1,181,735.

Q4 Fiscal Year 2009 saw an improvement in sales despite the continuing recession. This, combined with further reduced costs, brought the losses back down to \$573,225 for the quarter.



Despite a further increase in sales in Q1 Fiscal Year 2010, at \$570,530 losses barely changed from the previous quarter. The additional \$297,987 gross profit was offset mainly by legal fees relating to the TSX Venture Exchange review and new distributor agreement with Kemco Systems (\$84,185), four additional staff in the UK office (three from European Kemco operations plus a new sales person for the UK) plus an increase in travel costs within US.

The losses in Q2 2010 increased to \$1,010,630, again despite an increase in revenue. The increase in revenue resulted from sales of Kemco products, which attract lower margins than GEM Traps. In addition, provisions for potential liabilities with the former employees totalling \$248,050 were made in the current quarter, as well as a \$180,000 provision related to amounts owing pursuant to the Thermal-AUD™ financed contract.

Q3 Fiscal Year 2010 saw a decrease in net loss to \$646,842. Despite the revenue equalling that of Q1 2010, the loss was higher due to a higher percentage of the revenue in Q3 being generated from Solutions, hence a lower gross margin. The lower gross margins were offset by cost reductions within Administration and Selling, Marketing and Business Development.

In summary, other than Q3 and Q4 2009, in which the effects of the poor economic climate were most greatly felt, and Q3 2010, which includes January (traditionally the least busy month of the year), revenue has been steadily climbing. Losses, however, have fluctuated inconsistently, as detailed above. This demonstrates the need to significantly increase sales to cover and exceed the amount of fixed costs in order to overcome the consistent pattern of losses.

Outlook

On March 12, 2010, the Corporation announced its involvement in the UK based NHS Sustainable Development Conference 2010 as headline sponsor. The NHS is a publicly funded healthcare system in Great Britain working to reduce its energy consumption by 80% by 2050 in accordance with Government targets. Grant Bailey, Thermal Energy's Sales and Marketing Director for UK and Europe, demonstrated specifically on how Thermal Energy's products and solutions can help individual NHS Trusts and hospitals achieve their energy saving targets. The presentation was well received and attracted various enquiries from hospitals looking to achieve those targets. In addition to the presentation, Thermal Energy exhibited its wide range of Flu-Ace heat recovery solutions and GEM Venturi orifice steam traps.

On March 12, the Corporation announced the receipt of a purchase order for approximately \$475 thousand from Kings College Hospital Trust, a major teaching hospital in London, UK, to provide a FLU-ACE® heat recovery solution for use on its heating and hot water system.

On March 15, the Corporation announced that between February 23, 2010 and March 4, 2010 the Company cancelled 2,700,000 common shares. As part of its ongoing review of the Company's affairs, the TSX Venture Exchange identified certain deficiencies in the consideration received by the Company for the issuance of such shares. As a result, the



Company worked with the holders of such shares to arrange for their cancellation. All of the cancelled shares were originally issued on various dates in 2008.

On March 25, the Corporation announced that the Company and its former CFO Oliver Toffoli had settled a claim filed by Mr. Toffoli against the Company alleging wrongful dismissal and other damages related to Mr. Toffoli's past service with the Company. The terms of the settlement are confidential.

Critical Accounting Estimates

As previously announced, the Company is defending a lawsuit brought by a former president. Among other things, the lawsuit alleges that the former president was wrongfully dismissed from his employment. Damages are claimed in the amount of \$4 million, plus an as yet undetermined value of share options, interest and legal costs. The Company has filed a statement of defence in response and has counterclaimed for \$5.4 million in damages plus interest and costs. Two attempts have been made at a mediated settlement. Neither attempt has been successful. Although the lawsuit was commenced in October, 2005, the plaintiff has yet to take the proceeding to the point of oral examinations for discovery. As a result, there is much that is still unknown about the former president's case. Following the latest unsuccessful mediation in November, 2009, the Company has recorded a charge of \$190,000 in its financial statements. This charge is intended to account for possible net liabilities resulting from the claim and the counterclaim.

As at February 28, 2010, the financial statements of the Company are showing total assets of \$1,886,721 as Net Investment in Lease with a party that has filed for protection from its creditors under the Companies' Creditors Arrangement Act. Although the Company has taken a \$180,000 provision against the accounts receivable balance related to this lease, it has made no provision against the Net Investment in Lease, as it is expected that a new lease agreement will be negotiated during the restructuring process.

Changes in Accounting Policies

On February 13, 2009, the Accounting Standards Board confirmed that the use of International Financial Reporting Standards ("IFRS") will be required for Fiscal Years beginning on or after January 1, 2011 for publicly accountable profit-oriented enterprises. After that date, IFRS will replace Canadian GAAP for those enterprises. While IFRS is based on a conceptual framework similar to Canadian GAAP, there are significant differences with respect to recognition, measurement and disclosures. The Company is in the process of developing a plan for the implementation of IFRS and will assess the impact of the differences in accounting standards on the Company's consolidated financial statements. It is not possible to quantify the impact of these differences at this time. The Company expects to make changes to processes and systems before the 2012 Fiscal Year, in time to enable the Company to record transactions under IFRS. Training and additional resources will be utilized to ensure timely conversion to IFRS.



Summary of Outstanding Shares

The Company has 164,090,922 common shares issued and outstanding as at April 29, 2010.