



## Management Discussion and Analysis November 12, 2009

For the third quarter period ended September 30, 2009

---

This Management's Discussion and Analysis ("MD&A") should be read in conjunction with ProSep Inc.'s ("ProSep" or the "Company") Unaudited Interim Consolidated Financial Statements for the three month period ended September 30, 2009 and 2008 and should also be read with the Company's Annual Audited Consolidated Financial Statements and MD&A for the year ended December 31, 2008.

### Regulatory Filings

The Company's continuous disclosure material including interim filings, annual MD&A and Audited Consolidated Financial Statements, Annual Information Form and Notice of Annual Shareholder Meeting and Proxy Circular are available at [www.sedar.com](http://www.sedar.com) and on the Company's website at [www.prosepinc.com](http://www.prosepinc.com)

### Caution Regarding Forward-Looking Statements

This Management Discussion and Analysis may contain forward-looking statements, including statements regarding the business and anticipated financial performance of ProSep Inc. These statements are based, among others, on the Management's current assumptions, expectations, estimates, objectives, plans and intentions regarding projected revenues and expenses, the economic and industry environments in which the Company operates or which could affect its activities, the Company's ability to attract new clients and consumers as well as its operating costs, raw materials and energy supplies which are subject to a number of risks and uncertainties. Forward-looking statements can generally be identified by the use of the conditional tense, the words "may", "should", "would", "believe", "plan", "expect", "intend", "anticipate", "estimate", "foresee", "objective" or "continue" or the negative of these terms or variations of them or words and expressions of similar nature. Actual results could differ materially from the conclusion, forecast or projection stated in such forward-looking information. These statements are subject to a number of risks and uncertainties that may cause actual results to differ materially from those contemplated by the forward-looking statements. Some of the factors that could cause such differences include but are not limited to the Company's ability to develop, manufacture, and successfully commercialize value added equipments and services, the availability of funds and resources to continue its operations and pursue its projects, legislative or regulatory developments, competition, technological change, changes in government and economic policy, inflation and general economic conditions in geographic areas where ProSep Inc. operates. These and other factors should be considered carefully and undue reliance should not be placed on the forward-looking statements.

### Use of estimates

In the course of the preparation of financial statements in conformity with Canadian generally accepted accounting principles, management must make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses for the period. Actual results could differ from these estimates.

*All amounts are in Canadian Dollars unless otherwise specified*

## Non-GAAP Measurements

This MD&A contains the terms "cash flow before changes in non-cash working capital items", "earnings before interest, taxes, depreciation and amortization ("EBITDA") and "Net Unrestricted Working Capital" which should not be considered an alternative to or more meaningful than net earnings or cash flow from operating activities as determined in accordance with Canadian generally accepted accounting principles ("GAAP") as an indicator of the Company's performance. These terms do not have any standardized meaning as prescribed by GAAP. ProSep's determination of cash flow before changes in non-cash working capital items, EBITDA and Net Unrestricted Working Capital may not be comparative to that reported by other companies.

Management uses cash flow before changes in working capital items to analyze operating performance and leverage, and considers cash flow before changes in non-cash working capital items to be a key measure as it demonstrates the Company's ability to generate cash through the operations before working capital items. Cash flow before changes in working capital items is calculated using cash flow from operating activities as presented in the consolidated statement of cash flows before changes in working capital. The following table reconcile cash flow from operating activities and Cash flow form operating activities before changes in working capital items

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
	\$	\$	\$	\$
Cash flow from operating activities	(6 248 323)	(4 991 602)	(10 208 685)	(5 946 035)
Changes in operating working capital items	(4 736 145)	(5 805 382)	(7 696 420)	(6 060 331)
Cash flow before changes in working capital items	(1 512 178)	813 780	(2 512 265)	114 296

Management also uses EBITDA, among other measures, to assess the operating performance of the ongoing businesses without the effects of depreciation expense. ProSep excludes depreciation expense because it largely depends on the accounting methods and assumptions a company uses, as well as on non-operating factors such as the historical cost of capital assets. The following table reconcile EBITDA with net profit.

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
	\$	\$	\$	\$
Net loss and comprehensive loss	(3,440,258)	1,847,544	(12,572,626)	(1,652,392)
Plus				
Future tax recovery	128,383	(56,856)	100,011	(107,474)
Current tax provision	(74,047)	474,769	111,038	1,244,796
Amortization	410,637	359,685	1,180,816	1,100,826
Financial charges	2,742,592	(1,311,358)	4,773,825	1,213,864
Decrease in fair value of ABCP	(400,000)	-	(400,000)	450,000
Impairment of goodwill	-	-	6,500,000	-
<b>EBITDA</b>	<b>(632,693)</b>	<b>1,313,784</b>	<b>(306,936)</b>	<b>2,249,620</b>

Net Unrestricted Working Capital is also used by management to analyze available liquidity and anticipated short term in/out flows and is defined as current assets, excluding restricted cash, less current liabilities excluding accrual related to restricted cash. The following table shows calculation of this non GAAP measure

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
	\$	\$
<b>Total current assets</b>	<b>23 296 374</b>	<b>30 213 779</b>
<b>less restricted cash</b>	-	<b>1 037 846</b>
<b>Sub total (a)</b>	<b>23 296 374</b>	<b>29 175 933</b>
<b>Total current liabilities</b>	<b>16 176 723</b>	<b>36 469 778</b>
<b>less accrual related to restricted cash</b>	-	<b>1 037 846</b>
<b>Sub total (b)</b>	<b>16 176 723</b>	<b>35 431 932</b>
<b>Net unrestricted working capital (a minus b)</b>	<b>7 119 651</b>	<b>(6 255 999)</b>

### Comparative figures

Comparative figures for the financial information related to the three and nine month periods ended September 30, 2008 have been reclassified to be consistent with the September 30, 2009 presentation.

## TABLE OF CONTENTS

1.	OVERALL PERFORMANCE .....	5
1.1.	Highlights of the Period Ended September 30, 2009 and Subsequent Events.....	5
1.2.	Material Events and Important Subsequent Events .....	5
2.	COMPANY OVERVIEW .....	6
2.1.	Business Overview .....	6
2.2.	Corporate Model and Sales Network .....	6
2.3.	Business Environment .....	7
3.	PRODUCTS .....	8
3.1.	Market Segments and Product Penetration .....	8
3.2.	Product and Services Overview .....	8
4.	RESULTS OF OPERATIONS.....	9
4.1.	Contracts.....	9
4.2.	Revenues.....	9
4.3.	Cost of Goods Sold and Gross Margin.....	11
4.4.	Expenses and EBITDA*.....	12
4.5.	Goodwill Impairment.....	13
4.6.	Increase in fair value of ABCP.....	14
4.7.	Financial charges.....	14
4.8.	Income Tax.....	15
4.9.	Net Loss .....	15
4.10.	Other Items.....	15
4.10.1.	Legal proceedings .....	15
5.	SUMMARY OF QUARTERLY RESULTS .....	16
5.1.	Selected quarterly financial performance .....	16
6.	BALANCE SHEET ITEMS .....	16
6.1.	Assets .....	16
6.2.	Liabilities .....	17
6.3.	Equity.....	17
7.	OFF BALANCE SHEET ARRANGEMENTS .....	17
8.	LIQUIDITY AND CAPITAL RESOURCES .....	18
8.1.	Cash Flows.....	18
8.2.	Liquidity, working capital and credit facility.....	18
8.3.	Balance sheet restructuring: .....	20
9.	TRANSACTIONS WITH RELATED PARTIES .....	23
10.	DESCRIPTION OF CAPITAL STRUCTURE .....	23
11.	CRITICAL ACCOUNTING ESTIMATES.....	24
12.	FINANCIAL DISCLOSURE.....	24
12.1.	Disclosure controls and procedures.....	24
12.2.	Internal Control Over Financial Reporting .....	24
12.2.1.	Entity level controls .....	25
12.2.2.	Segregation of duties .....	26
13.	SELECTED RISKS.....	26

# 1. OVERALL PERFORMANCE

## 1.1. Highlights of the Period Ended September 30, 2009 and Subsequent Events

- Strengthened financial position and provided additional liquidities by converting \$8 million of principal amount of indebtedness into equity and subsequently completed a \$5 million rights offering to shareholders.
- Recorded revenues of \$9.2 million, a decrease of 27% from \$12.6 million during the corresponding period of 2008. Year-to-date, revenues are \$31.7 million, a 14% decrease from \$36.8 million during the corresponding period in 2008.
- Reported gross margin of \$2.7 million (29% of revenues) compared with \$4.1 million (33%) for the corresponding period of 2008. Year-to-date, gross margins are \$9.6 million (30%) compared with \$10.4 (28%) of revenues for the corresponding period of 2008.
- Generated negative EBITDA of \$0.6 million compared to a positive \$1.3 million for the corresponding quarter of 2008. Year-to-date, EBITDA stands at negative \$0.3 million compared to \$2.2 million in 2008.
- Recorded net loss of \$3.4 million or \$(0.03) per share (of which \$2.1 million or \$0.02 per share is a non-recurring and non-cash charge) for the quarter compared with a net income of \$1.8 million or \$0.03 per share for the corresponding period of 2008. Including the \$6.5 million impairment charge taken during Q2-09, year-to-date net loss stands at \$12.5 million or \$(0.14) per share compared to net loss of \$1.6 million or \$(0.03) per share for the corresponding period in 2008.
- Announced a \$12.9 million gas separation package supply agreement for Ecopetrol.
- Announced three contracts totalling \$1 million to supply proprietary technologies for BP, Conoco Phillips and Maersk.
- Ranked Deloitte's fastest growing technology company in Canada, twelfth in North America and received the coveted Leadership and Green Technology awards.
- As of October 1, 2009, sales backlog stood at \$22 million.

## 1.2. Material Events and Important Subsequent Events

In this section, all material events and commitments for the three-month period are presented, including information on important subsequent events, up to the date of this MD&A.

- On the date of this MD&A, ProSep announced changes to its Board of Directors with Bruno Ducharme's resignation as a Board and Audit Committee member for personal reasons. The Company expects to appoint a new candidate shortly.
- On October 7, 2009 ProSep announced it was awarded a US\$12.9 million contract to supply a CO<sub>2</sub> gas separation membrane package to Ecopetrol S.A., Colombia's state-owned Oil and Gas exploration and production company. The system, expected to be delivered during the second half of 2010, is designed to treat large volumes of natural gas and will be installed at the Cupiagua field in the Los Llanos foothills of Colombia.
- On October 1, 2009 ProSep announced it ranked first among the 2009 Deloitte Technology Fast 50<sup>TM</sup>, a ranking of the 50 fastest growing technology companies in Canada. ProSep also received the prestigious Leadership Award and Technology Green 15<sup>TM</sup> Award. Under the same program, the Company subsequently ranked 12<sup>th</sup> fastest growing technology company in North America.

- On August 24, 2009 ProSep announced the successful closing of its previously disclosed Rights Offering. A total of 38,461,538 Common Shares of the Company available were issued for gross proceeds of \$5 million.
- On July 16, 2009 ProSep announced the conclusion of the previously disclosed transaction to convert \$7,845,620 principal amount of indebtedness into Common Shares of the Company and, on July 14, 2009, announced the filing of a final prospectus with securities regulators to raise a maximum of \$10,000,000 by way of rights issue to shareholders. A group of debenture holders, shareholders, directors and executive officers have agreed to commit a minimum investment of \$4,840,000 to the Rights Issue. In view of ProSep's serious financial situation on June 17, 2009, the TSX granted the Company an exemption from a formal valuation and minority shareholder approval under the "financial hardship exemption", see section 8 for details.
- On July 8, 2009 ProSep announced it was awarded three contracts totalling approximately \$1 million (CAD) to supply its proprietary mixing technologies for installation at BP Norge, Conoco Phillips and Maersk Olie og Gas operations.

## 2. COMPANY OVERVIEW

### 2.1. Business Overview

ProSep designs, develops, manufactures, and commercializes process solutions to treat and purify oil, gas, and water for the O&G upstream industry. ProSep has a wide range of conventional and proprietary process equipment sold in units or in packages to O&G producers and engineering procurement and construction firms ("EPC") with or without process warranties.

Global Business Model: ProSep is a solutions provider supplying traditional and proprietary process equipment packages with process warranty.

ProSep provides: -In-house engineering from process to details; and  
-Direct and hands-on involvement with project management to include fabrication, assembly commissioning and services.

ProSep operates around the world in the most important O&G service hubs with operations in Houston (USA), Bergen (Norway), Fusa (Norway), Kuala Lumpur (Malaysia), and Manama (Bahrain). The head office is in Montreal (Canada).

ProSep has approximately 100 employees, mainly technical sales people, process engineers, product engineers and project managers and workers in the Houston assembly shop.

### 2.2. Corporate Model and Sales Network

ProSep has three diversified business units that promote all proprietary and conventional products across all regional markets. Each unit is a center of excellence based on the expertise and reputation it has built over the years and has its own engineering and sales teams and access to a wide network of agents.



### 2.3. Business Environment

Lower oil prices, lower demand and overall weakening in the global economic outlook has affected the level of investments in the O&G industry since the fall of 2008. Consequently, global upstream oil and gas investment budgets for 2009 have significantly been cut compared with the previous year<sup>1</sup>. Many projects were deferred or cancelled, with the bulk of postponed projects coming from the Canadian oil sands and non-OPEC countries and smaller O&G producers. For some equipment providers and other suppliers to the upstream O&G industry, this has resulted in decreased revenues and lower gross margins as competition has become more aggressive.

Expected recovery:

Recent encouraging economic data from Asia and America has recently prompted the International Energy Agency to increase its forecast for oil demand. Sustained upward movements in the price of oil has also lifted expectations of an expected recovery in upstream CAPEX spending. Since CAPEX investments are determined based on the economic viability of projects, sustained higher levels in the price of oil are an encouraging sign. Barclays Capital conducted an assessment of the state of investments in the industry and reported that over half of the 402 companies surveyed expected to increase their capital budgets in 2010. The report published in mid-June 2009 forecasts growth in E&P expenditures to return in 2010, with 32 percent predicting an increase of 20 percent or more<sup>2</sup>. More recently, Wood Mackenzie published a report that supports these findings and calls for upstream spending to return to growth by 2011<sup>3</sup> and reaching \$350 billion in 2012, up from current levels of \$325 billion.

ProSep's strategy:

ProSep continues to leverage its presence in active markets where investments have not been reduced or an expected uptake in the level of O&G E&P activities is most probable to occur within the next quarters. Since National Oil Companies ("NOC") have longer term expansion plans, are less dependent on capital markets and are slightly less sensitive to short-term variations in the price of oil, their investment projects were not as affected as independent O&G producers. ProSep's growing presence in these key markets where production costs tend to be lower, such as South East Asia and the Middle East, will remain important for future growth. With a stronger balance sheet, additional

<sup>1</sup> IEA sees 21% drop in E&P spend, March 25, 2009, Upstream online.

<sup>2</sup> Analysis: Industry Gears Up for Drilling as Crude Rises, June 26, 2009, Rigzone news.

<sup>3</sup> Scandinavian O&G Magazine, October 20, 2009. "Global upstream spending to return to growth by 2011 but caution prevails says Wood Mackenzie".

liquidities and strict controls over its cost structure, ProSep expects to be favorably positioned in the context of an anticipated recovery in the upstream O&G industry.

### 3. PRODUCTS

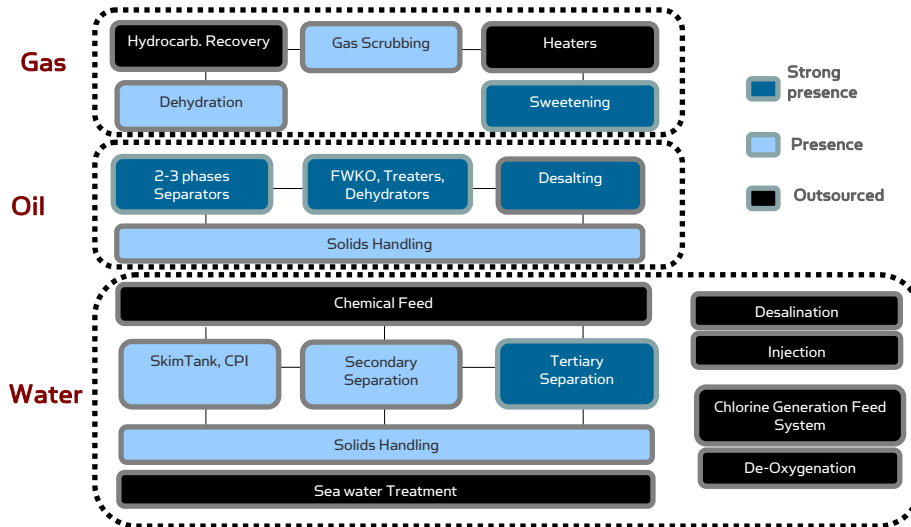
#### 3.1. Market Segments and Product Penetration

ProSep’s international team of engineers has developed extensive knowledge of process solutions for the upstream O&G treatment market. The Company’s expertise lies in three main production lines: produced water, oil and gas. ProSep designs customer specific solutions using its own products (a mix of proprietary and conventional technologies) and/or other solutions available on the market. A well diversified product offering and custom solutions-oriented service are key to ProSep’s value proposition. The following is a diagram of the Company’s product penetration within each treatment line.

#### 3.2. Product and Services Overview

Through its wide range of proprietary and conventional products, ProSep offers custom process solutions to O&G producers that wish to optimize their produced water, oil and gas treatment, separation and polishing activities. The Company has developed practical process solutions that deliver benefits to the environment, enabling O&G producers to meet industry and regulatory requirements while optimizing profitability, an important value-added proposition as production wells mature and volumes of produced water increase globally.

For a complete list and description of the Company’s conventional and proprietary offering, refer to the most recent Annual Management Discussion and Analysis document available at [www.sedar.com](http://www.sedar.com) and [www.prosepinc.com](http://www.prosepinc.com).



## 4. RESULTS OF OPERATIONS

### 4.1. Contracts

Sales come from several contracts to supply conventional and proprietary gas, oil and water treatment systems to large International Oil and Gas Companies as well as National Oil and Gas Companies. Our systems have been delivered and installed on oilfields around the world.

**Table of contracts announced since 2008**

Date	Value	Product	Customer	End User
Jan. 2008	US\$0.9 M	Engineering	Worley Parsons	BP Exploration
Apr. 2008	US\$1.4 M	Suction scrubber	Worley Parsons	BP Exploration
Apr. 2008	US\$11 M	Oil separation	Al-Rashed Co.	KOC
Apr. 2008	US\$13 M	Gas separation	Occidental Petro	Occidental Pet.
Jul. 2008	US\$4.8 M	Gas separation	Worley Parsons	BP Exploration
Jul. 2008	\$3.3 M	Glycol regen.	Petronas	Petronas
Sep. 2008	US\$1.1 M	ProSalt Mixer	PEMEX (Mexico)	PEMEX
Sep. 2008	n/a	TORR system	Fores Eng.	ENI and Inagip
Oct. 2008	US\$1.7 M	Gas conditioning	Powertium Eng.	Petronas
Oct. 2008	US\$2.3 M	Gas separation	Skanska LatinoA.	PDVSA
Nov. 2008	US\$1.8 M	Desalter	Hunt Refining	Hunt Refining
Jan. 2009	US\$3.7 M	Fuel gas package	Major EPC firm <sup>1</sup>	Asia Offshore IOC <sup>1</sup>
Feb. 2009	US\$1.2 M	Separator	Worley Parsons	BP Exploration
March 2009	US\$2.0 M	Fuel gas package	Powertium/MMHE	Petronas
March 2009	US\$2.1 M	Gas membrane units	Whiting Petroleum	Whiting Petroleum
May 2009	\$1.4 M	ProDry "JIP"	Total, Statoil, Con.Phil.	n/a
July 2009	\$1 M	ProSalt, ProDry	n/a	BP, Con.Phil, Maersk
October 2009	US\$12.9 M	Gas separation	Ecopetrol	Ecopetrol

<sup>1</sup> Client and end-user couldn't be revealed for competitive reasons.

### 4.2. Revenues

	US Operations	European & Middle-East operations	Asia Pacific operations	Product Development activities	Corporate Office	Consolidation & Inter segment eliminations	Consolidated operations
	\$	\$	\$	\$	\$	\$	\$
<b>For the three-month period ended September 30, 2009</b>	5 827 616	839 252	2 203 812	315 672	-	-	9 186 352
<b>For the three-month period ended September 30, 2008</b>	10 960 215	1 178 563	4 009 923	176 308	-	(168 172)	12 547 837
<b>For the nine-month period ended September 30, 2009</b>	21 058 141	3 091 789	7 230 887	723 202	-	(414 916)	31 689 103
<b>For the three-month period ended September 30, 2008</b>	31 721 605	4 067 705	1 641 154	436 240	-	(1 060 990)	36 805 714

### **Three-month period ended September 30:**

For the three-month period ended September 30, 2009 ProSep reported revenues of \$9,186,352, a 27% decrease from \$12,547,837 for the previous year. This decrease is partly attributable to lower revenues at the Company's US operations, that despite favourable exchange rates which contributed approximately \$0.3 million to revenues, reported third quarter 2009 sales of \$5,827,616 compared to \$10,960,215 for the corresponding period of 2008. Europe & Middle-East operations reported a 29% sales decrease from \$1,178,563 in Q3-08 to \$839,252 in Q3-09. Revenue decrease from these business units is a consequence of global reductions in investments in Oil and Gas expenditure programs (please refer to section 2.3 of this MD&A for an update on the current business environment). Specifically, many projects that the Company was asked to tender on were delayed or postponed and associated with stronger competition. It should be noted that the US operation recently signed a major USD 12.9 million contract with Ecopetrol leading to increased backlog and sustained revenues in the coming quarters. The Company continues to see encouraging results from its Asian business. During the third quarter of 2009, the Asia Pacific operations reported an important increase in revenues with sales of \$2,203,812; a 450% increase over the corresponding quarter of last year. Growth in ProSep's South-East Asian operations underlines the importance of this region, where FPSO (Floating Production Storage & Offloading) and gas opportunities are still important and where CAPEX spending has remained fairly strong. Since its inception in early 2007, this business unit gained credibility and a reputation in project execution, resulting in invitations to tender on larger projects. For the three-month period ended September 30, 2009 Product Development activities (PD) generated revenues of \$315,672, a close to 80% increase from \$176,308 for the previous year. Such PD activities consist of providing technical knowledge to Industry partners to develop and test new applications.

### **Nine-month period ended September 30:**

For the nine-month period ended September 30, 2009 ProSep reported revenues of \$31,689,103 a 14% decrease from \$36,805,714 in 2008. This decrease is mainly attributable to ProSep's American operations that were affected by the slowdown in US onshore and Gulf of Mexico offshore E&P spending. US Exchange rates positively impacted revenues from this business unit on a year-to-date basis, by contributing approximately \$2.8 million to reported sales of \$21,058,141 compared to \$31,721,605 for the corresponding period of 2008. The Europe & Middle-East operations reported revenue of \$3,091,789 a 24% decrease over \$4,067,705 reported during the nine-month period in 2008. Decrease in revenue from these business units relates to timing in contract completion and lower order intake. Asia Pacific operations reported an increase of 340% in sales, from \$1,641,154 to \$7,230,887. Revenues from this entity now represent about 23% of the Company's consolidated year-to-date revenues compared to a contribution of less than 5% in 2008. Revenue increase are mainly attributable to two important contracts for delivery of fuel gas packages. For the nine-month period ended September 30, 2009 ProSep reported Product development revenues of \$723,202 a 66% increase from \$436,240 in 2008. such increase is related to higher R&D activities with Industry partners.

### 4.3. Cost of Goods Sold and Gross Margin

		US Operations	European & Middle-East operations	Asia Pacific operations	Product Development activities	Corporate Office	Consolidation & Inter segment eliminations	Consolidated operations
		\$	\$	\$	\$	\$	\$	\$
For the three-month period ended September 30, 2009	Cost of good sold	4,307,571	175,183	1,745,753	295,441	-	-	6,523,948
	Gross margin	1,520,045	664,069	458,059	20,231	-	-	2,662,404
		26%	79%	21%	6%			29%
For the three-month period ended September 30, 2008	Cost of good sold	8,383,693	274,120	379,433	78,283	-	(168,172)	8,399,117
	Gross margin	2,576,522	1,452,683	21,490	98,026	-	-	4,148,720
		24%	123%	5%	56%			33%
For the nine-month period ended September 30, 2009	Cost of good sold	15,092,697	1,148,119	5,570,535	697,144	-	(414,916)	22,093,579
	Gross margin	5,965,444	1,943,670	1,660,352	26,058	-	-	9,595,524
		28%	63%	23%	4%			30%
For the nine-month period ended September 30, 2008	Cost of good sold	24,343,891	1,484,605	1,398,014	222,110	-	(1,060,990)	26,387,629
	Gross margin	7,377,714	2,583,101	243,140	214,131	-	-	10,418,085
		23%	64%	15%	49%			28%

Gross margin for the third quarter of 2009 was \$2,662,404 or 29% of revenues compared to \$4,148,720 or 33% of revenues for the comparative 2008 period. The unusually high 2008 margin is attributable the reversal of a warranty provision of \$1,280,471 taken during the second half of 2007 in relation to the delivery of seven TORR water treatment systems sold to SK Engineering & Construction. For the nine month period ended September 30, 2009 gross margin represented an unusually high 30% of revenues or \$9,595,524 and includes positive non recurring savings in commissioning of projects and increased labor component compared to material input in contracts delivered during the period. This compares to a 28% or \$10,418,085 margin a year before which included the provision reversal mentioned above.

Gross margins as a percentage of revenues at the American operations improved for both the third quarter at 26% for Q3-09 compared to 24% for Q3-08 and the nine month period at 28% for 2009 compared to 23% for the same period last year. This is mainly due to savings in commissioning of projects.

Gross margins as a percentage of revenues at the European & Middle-East operations were 79% for the third quarter of 2009, down from the unusual 123% reported in the corresponding quarter of 2008. Such high margin above the revenue level is related to the reversal of the warranty provision of \$1,280,471 mentioned above which did not have associated revenues. Excluding such reversal, the 2008 Q3 adjusted margin would have been 15%. The difference between the 2009 Q3 margin and the 2008 Q3 adjusted margin is a result of high contract completion costs in 2008 combined with higher labour components in 2009.

For the nine month period ended September 30, 2009 the gross margin stood at 63% compared to 64% for the corresponding period in 2008. Excluding the reversal of the warranty provision in 2008 the margin would have been 31%. The difference is related to high contract completion costs in 2008 combined with higher labour components in 2009.

Gross margins as a percentage of revenues at the Asia Pacific operations were 21% for the third quarter of 2009, compared to 5% for the corresponding quarter of 2008 and 23% year-to-date, up from 15% for the corresponding period of the previous year. Gross margin improvements reflect the higher level of sales allowing this business unit to capture operational synergies.

#### 4.4. Expenses and EBITDA\*

##### Detailed expenses and EBITDA for the 3 month periods ended September 30, 2009 and 2008

	<b>Three months ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
	<b>\$</b>	<b>\$</b>
<b>Revenue</b>	<b>9 186 352</b>	<b>12 547 837</b>
<b>Sales and marketing</b>	<b>539 185</b>	<b>491 551</b>
<b>Research and development</b>	<b>95 140</b>	<b>353 922</b>
<b>General and administrative</b>	<b>2 660 772</b>	<b>1 989 463</b>
	<b>3 295 097</b>	<b>2 834 936</b>
<b>EBITDA</b>	<b>(632 693)</b>	<b>1 313 784</b>

##### Detailed expenses and EBITDA for the 9 month periods ended September 30, 2009 and 2008

	<b>Nine months ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
	<b>\$</b>	<b>\$</b>
<b>Revenue</b>	<b>31 689 103</b>	<b>36 805 714</b>
<b>Sales and marketing</b>	<b>1 644 836</b>	<b>1 481 606</b>
<b>Research and development</b>	<b>395 773</b>	<b>921 705</b>
<b>General and administrative</b>	<b>7 861 851</b>	<b>5 765 154</b>
	<b>9 902 460</b>	<b>8 168 465</b>
<b>EBITDA</b>	<b>(306 936)</b>	<b>2 249 620</b>

\* EBITDA is a non-GAAP measure and the Company defines it as earnings or loss from operations excluding depreciation and amortization, financial charges and income taxes. Please refer to section called non GAAP measurement

Earnings before interest, taxes, depreciation and amortisation (EBITDA) were (\$632,693) for the three-month period ended September 30, 2009 compared with \$1,313,784 for the same period in 2008. This \$1,946,477 decrease is mostly attributable the reversal in the third quarter of 2008 of a warranty provision of \$1,280,471 taken during the second half of 2007 in relation to the delivery of seven TORR water treatment systems sold to SK Engineering & Construction. The remaining difference is related to the decrease in revenue and resulting gross margin but also to increased Sales and marketing expenses and General and administrative expenses (see below).

When comparing the nine month period ended September 30, 2009 and 2008, the EBITDA stood at (\$306,936) in 2009 compared to \$2,249,620 in 2008. Here again the decrease is related to the reversal of the warranty provision in 2008, lower sales level and increased sales and marketing expenses and general and administrative expenses (see below).

## **Sales and Marketing Expenses**

Sales and marketing expenses were \$539,185 or 6% of revenue for the three-month period ended September 30, 2009 compared to \$491,551 or 4% for the three-month period ended September 30, 2008. This increase is mainly related to the US operations that introduced a new conventional produced water line and dedicated more resources to support the increased level of quotations.

For the nine month period ended September 30, 2009 sales and marketing expenses were \$1,644,836 (5% of revenue) compared to \$1,481,606 (4% of revenue) for the previous year. The increase is the result of the above mentioned additional resources of the US compensated by reductions in the Company's sales and marketing team in Norway and better cost control measures that took place in the second quarter of 2008.

The majority of the sales and marketing expenses relate to salaries, marketing, promotional and travel activities.

## **Research and Development Expenses**

Research and development expenses decreased to \$95,140 in the three-month period ended September 30, 2009 from \$353,922 in the three-month period ended September 30, 2008. For the nine month period ended September 30, 2009 R&D expenses were \$395,773 compared to \$921,705 the previous year. Reductions in these expenses reflect a higher allocation of R&D resources to projects conducted in collaboration with industry partners.

### ProSep's R&D model:

Development activities are conducted under the umbrella of joint industry partnerships (JIP) with super major oil and gas companies. This is a highly efficient collaboration model that allows the Company to develop pioneering technologies by addressing a fair portion of project financing needs and validate market interest before the applications reach commercialization. The Company retains all property rights including technology, patents and licensing fees relating to future sales of all products developed.

## **General and Administrative Expenses**

General and administrative ("G&A") expenses were \$2,660,772 for the three-month period ended September 30, 2009 compared to \$1,989,463 for the three-month period ended September 30, 2008. The increase in quarterly G&A expenses of \$671,309 is partially explained by a higher US conversion rate which accounts for about \$0.2 million. The balance of the increase is attributable to the new Bahrain office, new fabrication and assembly shop in the US and increased resources needed to support the growing Asia Pacific operation. Additionally, the reduced level of activity in the Europe & Middle-East business unit added pressure on G&A expenses due to lower staff cost allocation to contracts as well as the addition of a General Manager and Administrative Manager. Finally, a portion of the increase is explained by new hires at the Asia Pacific unit in line with increased level of activities.

For the nine month period ended September 30, 2009 G&A expenses were \$7,861,851 compared to \$5,765,154 for the corresponding period of 2008. The higher US conversion rate explains about \$0.6 million of the increase. The remaining increase is related to same factors as mentioned above.

## **4.5. Goodwill Impairment**

Goodwill represents the excess of the purchase price of an acquired business over the fair value of the identifiable assets acquired and liabilities assumed. Management tests for impairment of goodwill on an annual basis and at any other time if events occur or circumstances change that would indicate that

it is more likely than not that the fair value of a reporting unit has been reduced below its carrying amount.

Factors considered important which could trigger an impairment review include, but are not limited to, significant underperformance relative to expected historical or projected future operating results, significant changes in the manner of use of the acquired assets or the strategy for the overall business, a downturn in the Canadian and international economies, significant negative industry or economic trends, a significant decline in the stock price for a sustained period and the Company's market capitalization relative to net book value.

The goodwill impairment test is a two-step process. Step one consists of a comparison of the fair value of a reporting unit with its carrying amount, including the goodwill allocated to the reporting unit. Measurement of the fair value of a reporting unit may be based on one or more fair value measures including present value techniques of estimated future cash flows and estimated amounts at which the unit as a whole could be bought or sold in a current transaction between willing parties. If the carrying amount of a reporting unit exceeds the fair value, step two requires the fair value of the reporting unit to be allocated to the underlying assets and liabilities of that reporting unit, resulting in an implied fair value of goodwill. If the carrying amount of the goodwill of the reporting unit exceeds the implied fair value of that goodwill, an impairment loss equal to the excess is recorded in net earnings (loss).

In light of the balance sheet restructuring initiative, for which details can be found in the section 8 of this MD&A, the Company has performed in the second quarter an interim testing of the goodwill valuation. Such test considered at the time the estimated impact of the balance sheet restructuring initiative, comprised of \$7,845,620 principal amount of indebtedness conversion into shares and committed amount under the share rights offering of \$4,840,000, and has estimated the anticipated fair value of the Company using a price of \$0.13 per share which represents the conversion price of the debenture (announced in September 2009 and closed on July 16, 2009).

Based on the preliminary estimates of step one of the process, the Company determined in the second quarter that the anticipated value of ProSep is below its expected carrying value and that impairment loss of goodwill was probable. Accordingly, an impairment charge of \$6.5 million was estimated and recorded in the second quarter. This charge was allocated to the business units using their respective estimated value. Management has not yet performed step two due to time constraints, but will proceed in the future. This could result in potential further write down of goodwill.

#### **4.6. Increase in fair value of ABCP**

During the three month period ended September 30, 2009, an increase of \$400,000 in the fair value of the investment in asset backed commercial paper was recorded. The nine-month period ended September 30 2008, includes an impairment charge of \$450,000 which was recorded in the first quarter of 2008. Please refer to note 9 of the September 30, 2009 consolidated financial statements for more details.

#### **4.7. Financial charges**

Total financial charges were \$2,742,592 for the three-month period ended September 30, 2009 compared to (\$1,311,358) for the corresponding 2008 period. This increase is mainly related to a \$1.9 million foreign exchange gain in 2008 compared to a foreign exchange loss of \$403,150 in Q3 09. The foreign exchange gain and loss are mainly the consequence of the US and Norwegian division's balance sheet conversion. Also a loss \$2,071,543 related to the induced conversion and settlement of debts completed in Q3 09 explains most of the remaining difference. This non cash loss is the direct consequence of the induced debt conversions and settlements that was part of the balance sheet restructuring detailed in section 8.3 below.

For the nine-month period ended September 30, 2009 the total financial charges stood at \$4,773,825 compared to \$1,213,864 for the corresponding 2008 period. The increase is again mainly related to a foreign exchange gain recorded in 2008. This gain of \$532,420 compares to a foreign exchange loss of \$976,038 during the nine month period ended September 30, 2009. The remaining difference is caused by the loss of \$2,076,964 related to the induced conversions and settlements of debentures recorded in Q3 09.

#### **4.8. Income Tax**

Income taxes were \$54,336 for the three-month period ended September 30, 2009 compared to \$417,913 for the corresponding period of 2008. For the nine-month period ended September 30, 2009 the income taxes represented \$211,049 compared to \$1,137,322 for the same 2008 period. Overall lower tax expenses are in line with lower revenues at the US operation. The Company's operating revenues and expenses are reported by various business units located around the world and subject to various fiscal jurisdictions. Some of these business units are profitable while others have yet to generate net income while others have accumulated tax losses. ProSep's management is working on optimizing the Company's tax structure.

#### **4.9. Net Loss**

The Company reported a net loss of \$3,440,258 or \$0.03 per share for the three-month period ended September 30, 2009 compared to a net profit of \$1,847,544 or \$0.03 per share for the three-month period ended September 30, 2008. The increase in the net quarterly loss is mostly attributable to lower EBITDA (see above) but also to the loss on a financial instrument of \$2.1 million in relation with the debt conversion (see section 8.3 below) and to the 2008 warranty provision reversal of \$1.2 million.

For the nine month period ended September 30, 2009 net loss was \$12,572,626 or (\$0.14) per share compared to a net loss of \$1,652,392 or (\$0.03) per share for the corresponding period in 2008. The variation in the net loss of about (\$11) million is largely attributable to a lower EBITDA (see above), the \$6.5 million write-down of goodwill recorded in Q2 09 (see above section 4.5), the loss of \$2.1 million on a financial instrument, the difference in foreign exchange gain of \$1.5 million and the 2008 warranty provision reversal of \$1.2 million.

#### **4.10. Other Items**

##### **4.10.1. Legal proceedings**

ProSep has a policy to defend its intellectual property firmly and with conviction. In October 2005, the Company initiated legal proceedings before the Québec Superior Court against a former employee and related parties seeking injunctive relief for misappropriation and illegal use of proprietary information belonging to the Company.

On November 5, 2009, the Company reached a settlement of its litigation with Defendants Separatech Canada Inc. ("Separatech"), Neil Sutcliffe and Amine Benachenhou. The terms of the agreement provide that ProSep Inc. will receive a payment equal to 3% of Separatech's gross revenues, up to maximum of CDN\$100,000, for the period March 31, 2003 to March 31. In addition, the Company will receive 2.5% of Separatech's gross revenue for the next 10.5 years. At any time over the next 10.5 years, the defendants will be able terminate the Agreement by paying ProSep a lump sum of CDN\$2,000,000. The defendants have also granted a first option to ProSep Inc. to buy Separatech's patent for 1\$, should the defendants decide to abandon it.

Both parties have agreed to file a Declaration of Out of Court Settlement. No revenues for this settlement were recorded during Q3. ProSep is the defendant in a claim made by Westend Enviro Consultants ("Westend"). Westend commenced an action in the Supreme Court of British Columbia on March 31, 2006 claiming damages for breach of contract and fraudulent misrepresentation. Westend

claims that ProSep entered into an agreement with it to provide equipment and a chemical for remediation work on a site in B.C. Westend alleges that it paid a total of \$280,000 to ProSep and that it did not ever receive the specified chemical, thereby making the machine worthless. The amount of the claim as stated in the pleading is \$280,000. ProSep filed a Statement of Defence on June 9, 2006, denying any liability. Document discovery has largely been completed. Examinations for discovery have been conducted. Further information and document requests have been answered. No trial date has been scheduled. It is premature to assess the likelihood of successfully defending this claim. No amount has been recorded as of September 30, 2009.

## 5. SUMMARY OF QUARTERLY RESULTS

### 5.1. Selected quarterly financial performance

	Year Ending December 31, 2009			Year Ending December 31, 2008				Nine-Month Period Ending December 31, 2007		Year Ending September 30, 2007		
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q2	Q1	Q4	Q3	Q2
Revenue	9,186	9,316	13,187	14,798	12,548	15,141	9,117	5,683	102	9,402	16,415	170
Net income (loss)	(\$3,440)	(\$7,148)	(\$1,985)	27 <sup>1</sup>	1,848 <sup>2</sup>	(162)	(3,338)	(5,012)	(3,063)	(2,928) <sup>3</sup>	(1,864) <sup>4</sup>	(1,777)
Basic EPS (loss)	(0.02)	(0.11)	(0.03)	0.00	0.03	(0.00)	(0.05)	(0.09)	(0.07)	(0.06)	(0.04)	(0.04)
Diluted EPS (loss)	n/a	n/a	n/a	0.00	0.03	n/a	n/a	n/a	n/a	n/a	n/a	n/a

\*EPS: Earnings per share

Revenue and income are in thousands, all amounts are in CAD \$.

<sup>1</sup>Net income includes a reversal of \$1,280,921 of warranty provision and \$1,645,356 gain on foreign exchange

<sup>2</sup>Net income includes a reversal of \$1,280,920 of warranty provision and \$1,886,988 gain on foreign exchange

<sup>3</sup>Net loss includes a \$1,385,008 warranty provision

<sup>4</sup>Net loss includes a \$1,176,833 warranty provision

## 6. BALANCE SHEET ITEMS

### 6.1. Assets

Total assets as at September 30, 2009 were \$52,039,068 a decrease of \$17,456,542 from the December 31, 2008 amount of \$69,495,610. As at September 30, 2009 ProSep had \$2,680,662 in cash and cash equivalents compared with \$7,615,119 as at December 31, 2008. As at December 31, 2008, ProSep had \$1,037,846 of short term restricted cash related to the acquisition of Pure Group AS. During the second quarter of 2009 most of this amount was released to the seller. The Company's receivables were \$18,862,626 as at September 30, 2009 compared to the December 31, 2008 amount of \$20,004,848. This decrease is in line with the year to date revenue reduction. As at December 31, 2008, ProSep had \$3,158,986 (18,000,000 NOK) of long term restricted cash

required under the credit facility with DNB Nor. On April 29 2009, the Company agreed to a new covenant structure on this credit facility which enabled the release of this amount.

Total long term investments stood at \$5,827,424 as of September 30, 2009. The variation from \$5,815,000 as at December 31, 2008 is the result of an increase of \$400,000 due to the re-evaluation (see 4.6 above) less net interest received of \$387,576.

Goodwill totalled \$13,907,126 as at September 30, 2009 a decrease of \$6,500,000 from December 31, 2008. Such decrease is related to a write-down taken in the second quarter of 2009. (Refer to section 4.5 for more details).

## **6.2. Liabilities**

Total liabilities at September 30, 2009 were \$32,769,036 representing a decrease of \$17,195,672 from the December 31, 2008 amount of \$49,964,708. The variance is mainly a result of a decrease of the DnBNor bank credit facility from \$4,396,044 at December 31, 2008 to \$2,565,602 on September 30, 2009. Accounts payable and accrued liabilities account for \$9,264,687 of the decrease which is related to advancement and completion of major contracts.

In April 2009, the company accepted the offer from National Bank of Canada whereby the ABCP related term loan maturing in April 2009 was replaced by two long term revolving credit facilities totalling \$7,180,564.

For more information on the Company's debt structure and the impact of the debt conversion, refer to notes 10 and 11 of the financial statements.

## **6.3. Equity**

The Company's net equity as at September 30, 2009, was \$19,270,032, compared to \$19,530,902 as at December 31, 2008. The variation is the result of the the nine-month period ended September 30, 2009 net loss compensated by both the debt conversion on the rights offerig.(See section 8,4 below)

As of September 30, 2009 ProSep had 163,255,910 common shares issued and outstanding, compared to 64,443,451 on December 31, 2008.

# **7. OFF BALANCE SHEET ARRANGEMENTS**

During the year ended December 31, 2008 ProSep entered into a commitment lease agreement for a new 55,000 square feet manufacturing and assembly facility located in Houston, Texas. The Company has moved its manufacturing and assembly capacity to this new premise during the second quarter of 2009. This expansion will enable the Company to double the size of its Houston facility and allow for a significant increase in its production capacity as well as diversify its product offering.

## 8. LIQUIDITY AND CAPITAL RESOURCES

### 8.1. Cash Flows

#### Operating activities

During the three-month period ended September 30, 2009, ProSep generated a negative cash flow from operations of \$6,248,323 compared to a negative \$4,991,602 in the same period in 2008. During the nine-month period ended September 30, 2009, ProSep generated a negative cash flow from operations of \$10,208,685 compared to a negative \$5,946,035 in 2008.

Operating cash flows for the quarter ended September 30, 2009 decreased from the corresponding 2008 quarter due to lower EBITDA level compensated by lower investment in non cash working capital. For the nine month period ended September 30, 2009 the difference in cash flow from operations compared to the corresponding 2008 period is due to higher investment in non cash working capital combined with lower EBITDA level.

#### Investing activities

Investments during both the quarter and the nine-month period ended September 30, 2009 were mostly made in property & equipment to equip the new 55,000 square foot assembly facility in Houston as well as in computer equipment.

#### Financing activities

Difference in financing activities for the quarter ended September 30, 2009 compared to the respective period of 2008 is mostly related to the Rights offering which generated slightly over \$4 million of net proceeds (see section 8,3)

Differences in financing activities for the nine-month period ended September 30, 2009 compared to the respective period of 2008 are mostly related to the release of the restricted cash (see section 6.1), the variation in the short term credit facility, the Q2 2008 financing and finally, the Rights offering mentioned above.

### 8.2. Liquidity, working capital and credit facility

As at September 30, 2009, ProSep had \$2,680,662 of cash and cash equivalents. On December 31, 2008, the Company had \$7,615,119 of cash and cash equivalents, \$1,037,846 of short term restricted cash and \$3,158,986 of long term restricted cash. See note 7 of the September 30, 2009 financial statements for more details on the restricted cash.

As at September 30, 2009 ProSep had net unrestricted working capital of \$7.2 million (non GAAP measure defined for the purpose of this section as current assets, excluding restricted cash, less current liabilities excluding accrual related to restricted cash), compared to a negative \$6.3 million as at December 31, 2008. Such improvement in the unrestricted working capital level is mainly related to the \$7.2M National Bank short term loan that was converted into a long term loan but also to lower accounts payable and accrued liabilities.

Principal use of working capital is to provide for the financing of various contracts. The level of working capital can be quite volatile during a given period, depending on contract advancements. A portion of the working capital is financed through customer advances or progress payments on contracts. In some cases, such advances or payments require the issuance of letters of guarantee

(LG) using the DnB Nor 15 million NOK facility (\$2,782,518 at September 30, 2009) or support provided by Export Development Canada (“EDC”). As at September 30, 2009 the total (DNB & EDC) outstanding LG were \$2,447,105 (\$4,002,231 as at December 31, 2008).

**National Bank loan:** As of December 31, 2008, credit facilities included \$7.2 million of short term loan with National Bank which was converted in April 2009 into two long term revolving credit facilities (please refer to note 11 of the financial statements as of September 30, 2009 for more details).

**DNB Nor release of restricted cash:** At December 31, 2008, the Company was in breach of one of its financial covenant under the credit facility with DnB NOR. The breached covenant called for ProSep to repay entirely the line of credit twice a year. Due to the increase in backlog, ProSep required full usage of its working capital resources and was thus unable to comply with this covenant in due time. A long term waiver was obtained for such covenant breach. In exchange for the waiver, the Company agreed to maintain an amount of 18,000,000 NOK in a separate escrowed bank account to be held until determination of a new covenant structure. In April 2009, DnB Nor Bank ASA agreed to a new covenant structure outlining its 45,000,000 NOK loan facility (31,500,000 NOK at September 30, 2009) so as to release the 18,000,000 NOK (approximately \$3.4 million as of April 30, 2009) previously escrowed pending the renegotiation relating to the new covenant structure.

**ProSep’s current bank credit facilities:**

Credit facilities as of September 30, 2009

Lender	Description	Currency	Amount (CAD)	Drawn (CAD)	Available (CAD)
DnB Nor	Overdraft	NOK/USD	\$5,472,286	\$2,565,602	\$2,906,684
	F/X forward facility	NOK	\$92,751	\$0	\$92,751
	Guarantee facility	NOK	\$2,782,518	\$2,169,071	\$603,501

**ProSep’s debt and credit facilities repayment schedule as of September 30, 2009**

	Carrying Amount	One – nine months	Nine - twelve months	One – five years	More than five years
<b>Bank credit facilities</b>	\$2,565,602	-	\$2,565,602	-	-
<b>Long Term debt</b>	\$16,739,136	\$1,708,146	\$12,907	\$15,018,083	-
<b>Total</b>	\$19,304,738	\$1,708,146	\$2,578,509	\$15,018,083	-

ProSep Inc is a company with limited business operations, sources of income or operating assets other than the shares of its subsidiaries, operating companies and TORR technology. ProSep's cash flow and, consequently, its ability to meet its debt service obligations is highly dependent upon the receipt of funds from its subsidiaries in the form of loans, dividends, advances or otherwise. As mentioned above, the Company entered in April 2009 into an amended covenant structure in relation to the DnB loan facility. Under this amended debt agreement, ProSep is subject to certain financial and negative covenants, including restrictions on ability to incur indebtedness, pay dividends, make certain other payments, create liens, sell assets and engage in mergers. The operating subsidiaries of the Company are also restricted from transferring funds in the form of dividends, loans or otherwise to the Company in excess of \$3.7 million for fiscal year 2009. Therefore, considering the Company’s debt obligations, debt repayment schedules and negative cash flow from operating activities the company had, ProSep initiated early 2009 a balance sheet restructuring program to recapitalize the Company, negotiate repayment schedules and reduce overall debt. This balance sheet restructuring was completed on August 24<sup>th</sup>, 2009. Details of such restructuring are presented in the section below.

### 8.3. Balance sheet restructuring:

In order to restructure its balance sheet and remedy to the above mentioned difficult financial situation, the Company announced on June 17, 2009 its intention to convert a significant portion of its outstanding debentures into equity and initiated a Rights Offering to its shareholders to raise a maximum of \$10 million (including a firm commitment of \$4.9 million from a group of debenture holders, shareholders, directors and executive officers of the Company). This restructuring has reduced overall debt and will preserve cash for operations rather than debt servicing .

This initiative consisted of:

- Filing of a short form prospectus for a Rights Offering to Shareholders as of July 24, 2009 ("the Record Date") to raise a maximum of \$10,000,000 with a firm commitment of \$4.9 million from a group of debenture holders, shareholders, directors and executives of the Company; and
- An agreement with the holders of its existing debentures to convert \$7,845,620 of principal amount of indebtedness into common shares of ProSep by amending the terms of the Company's existing Debentures and to participate in the Rights Offering, as mentioned in the previous bullet, so as to ensure that ProSep realizes gross proceeds of at least \$4.9 million.

Overall, this initiative reduced the principal amount of the indebtedness by \$7,845,620, short term debt repayment obligations by over \$2,444,000 and provided \$3.9 million of cash representing gross proceeds from the Rights Offering less the cost thereof (\$0.88 million) and debt conversion cost (\$0.2 million).

The improved balance sheet resulting from the transaction will enable ProSep to finance its future capital requirements from cash on hand and cash flow from operating activities.

In addition, it should be noted that ProSep's ability to generate operating income and therefore cash flow from operating activities is reliant on the underlying health of the O&G industry. The global economic environment affects demand for oil and gas, thus affecting the price of these commodities and, in turn, the industry's willingness to invest in exploration and development CAPEX, including in the types of process equipment and services provided by the Company and its subsidiaries. Any substantial reduction in demand for oil and gas as a result of a global recession, accompanied by lower prices and reductions in CAPEX programs, could therefore negatively impact ProSep's business.

Since the Company's incorporation, operating results have fluctuated and there can be no assurance that ProSep will operate profitably in the future. Considering general economic conditions, operating results may vary from quarter to quarter, depending on a number of factors, including:

- the introduction and market acceptance of new products and new variations of existing products;
- the activities of competitors;
- ability to control expenses;
- variations in the timing of orders and subsequent shipments;
- the length of customers' approval processes or market tests;
- changes in product mix;
- lack of liquidity;
- changes in capital spending;
- unforeseeable or unavoidable delays in large-scale customer projects;
- higher interest rates;
- changes in currency rates.

Because quarterly revenues could be dependent upon a relatively small number of large transactions, even minor variations in the rate and timing of conversion of sales prospects into revenue could cause the Company to plan or budget inaccurately, and such variations could adversely affect our financial results. Delays, reductions in amounts or cancellations of customers' purchases could adversely affect the business, financial condition and results of operations. In light of the foregoing, quarter-to-quarter comparisons of operating results are not necessarily meaningful and should not be relied upon as indications of likely future performance or annual operating results.

**Details of the debenture amendments and conversions:**

The Company had the following debts outstanding before the July 16, 2009 amendments and conversions:

- i) \$1,500,000 principal amount 12% Secured Convertible Debentures due October 29, 2009
- ii) US\$4,000,000 principal amount 13.25% Unsecured Debentures with a final maturity date of April 1, 2013; and
- iii) \$5,090,000 principal amount 13% Unsecured Convertible Debentures due April 23, 2013.

Holders of these debentures agreed to amend the terms of these Debentures and to partially convert (representing an amount of \$7,178,500), at an amended conversion price of \$0.13, such Debentures and \$667,120 of accrued interest into an aggregate of 60,350,923 Common Shares.

Shares received from these conversions settled before the Record Date for the Rights Offering of July 24, 2009. Certain holders of Debentures have further agreed to exercise the Rights attached to all the Common Shares they hold as of the Record Date pursuant to their Basic Subscription Privileges and, if required, Additional Subscription Privileges to the fullest extent permitted by securities laws, ensuring that ProSep realizes gross proceeds from the Rights Offering of at least \$4,840,000.

Amendments and conversions to the debentures were as follows:

- (i) \$1,500,000 principal amount 12% Secured Convertible Debentures were entirely converted into Common Shares at the amended conversion price of \$0.13;
- (ii) the US\$4,000,000 principal amount 13.25% Unsecured Debentures was converted as part of the \$5,090,000 principal amount 13% Unsecured Convertible Debentures of equivalent principal amount with a final maturity date of April 23, 2013; and
- (iii) Out of this new 13% Unsecured Convertible Debentures, \$5,678,500 principal amount was converted into Common Shares at the amended conversion price of \$0.13 (reduced from \$0.45).

As a result, the remaining Debentures outstanding have a principal amount of \$3,953,500. The Debentures bear interest at an annual rate of 13.25% (increased from 13%) and the maturity date was extended from April 23, 2013 to the fifth anniversary of the Amendments. The amended Debentures are convertible, at the option of the holders, into Common Shares based on a conversion price of \$0.30 and redeemable in whole or in part by the Company at any time after the second anniversary of the Amendments. Interest is payable every six months in cash.

The closing of the Amendments, which was subject to regulatory approval (including approval by the Toronto Stock Exchange) (the "TSX") and to other customary closing conditions, occurred on July 16, 2009.

For accounting purposes, these transactions have been accounted for as either inducements to convert or settlements of the previous liabilities, and losses on settlements totalling \$2,071,543 have been recognized in the consolidated statement of earnings and a charge of \$2,198,397 has been

recorded to retained earnings. The remaining Unsecured Convertible Debentures are considered new compound debt instruments and accordingly include a liability component and an equity component. Please refer to Note 12 (a) to the unaudited interim consolidated financial statements for further details.

The 60,350,921 Common Shares issued as a result of the Amendments represented 94% of all the issued and outstanding Common Shares immediately before the conversion.

#### **Financial hardship exemption and TSX delisting review:**

The Amendments were unanimously approved by all directors of the Company who are free from any interest and unrelated to the parties involved in the proposed transaction. Some of these Amendments were impacted by *Multilateral Instrument 61-101 – Protection of Minority Shareholders in Special Transactions* ("MI 61-101"). The Company relied on the financial hardship exemption included in Sections 5.5(g) and 5.7(e) of MI 61-101 to be exempted from the requirement for a formal valuation and a minority shareholder approval. In addition, the Company applied to the TSX for an exemption, in accordance with Section 604(e) of the TSX Company Manual, from the requirement to obtain shareholder approval for the Amendments in consideration of the serious financial circumstances of the Company, as described in the Management's Discussion and Analysis for the period ended March 31, 2009. The TSX requires shareholder approval when the number of Common Shares to be issued under such transactions exceeds a 25% dilution. In this context, the terms of the Debentures were amended mainly to provide for a reduced conversion price for the Debentures that was lower than the market price, less the permissible discount under TSX rules, and the fact that the transaction could materially affect the control of the Company because of the increased share ownership of FondAction.

ProSep's reliance on this exemption automatically results in a TSX de-listing review. This process is intended to insure that ProSep continues to meet TSX listing requirements. The Company's reliance on the financial hardship exemption provisions under MI 61-101 and the TSX Company Manual is based on determinations by the board of directors of ProSep and all of its independent directors, acting in good faith, that the Company was in serious financial difficulty, that the transaction was designed to improve its financial position and that the terms of the transaction are reasonable under such circumstances.

The Company was granted 210 days in which to regain compliance with the TSX listing requirements, pursuant to the Remedial Review Process. ProSep intends to comply with all the continued listing requirements as set forth in Part VII of the TSX Company Manual available on the TSX website. and believes it will be able to address this with the TSX before the deadline.

#### **Details of the Rights Offering:**

On July 14, 2009, ProSep filed a final short form prospectus to raise a maximum of \$10,000,000 in gross proceeds by issuing to shareholders (that are residents of Canada and eligible shareholders in other jurisdictions of record on July 24, 2009, one right for each common share of ProSep held. The Rights entitled Eligible Holders to subscribe for and purchase from the Company an aggregate of approximately 76,923,077 Common Shares (assuming full subscription). 1.6223 Rights entitle the holder to subscribe for one Common Share at the subscription price of \$0.13 on or before the expiration date which was August 20, 2009. On August 24, the Company announced that a total of 38,461,538 shares were subscribed for total gross proceeds of \$5 million. After considering all transaction costs (including debt conversion costs), total net proceeds of \$3.9M were made available to the Company to: (i) fund lines of credit necessary to ensure proper investment in working capital; (ii) issue performance bonds to customers; and (iii) invest in capital expenditures mainly in small equipment for the Houston plant, and some demonstration pilot units of our proprietary products. Moreover, the lower debt to equity ratio and the cash available should enable ProSep to have greater access to Export Development Canada guarantee programs and negotiate better lines of credit and lines for issuing guarantees with the Company's bank.

Following the closing of the Amendments that occurred on July 16, 2009 and the rights offering that closed on August 24, 2009, ProSep has a total of 163,255,910 Common Shares issued and outstanding.

## 9. TRANSACTIONS WITH RELATED PARTIES

During the quarter ended September 30, 2009 ProSep did not make any transactions with related parties.

## 10. DESCRIPTION OF CAPITAL STRUCTURE

ProSep's authorized share capital consists of an unlimited number of common shares, of which 163,255,910 common shares are issued and outstanding on September 30, 2009. The Company is authorized to issue an unlimited number of common shares without par value. The holders of the common shares are entitled to receive notice of and to attend all annual and special meetings of shareholders and to one vote in respect of each common share held at all such meetings. The holders of the common shares are entitled, at the discretion of the Company's Board of Directors, to receive any or all of profits or surplus properly available for the payment of dividends, as well as any dividend declared by the Board of Directors and payable by the Company on the common shares. The holders of the common shares will participate rateably in any distribution of the Company's assets upon liquidation, dissolution or winding-up or other distribution of assets among shareholders for the purpose of winding up the Company's affairs. Such participation will be subject to the rights, privileges, restrictions and conditions attached to any securities issued and outstanding at such time ranking in priority to the common shares upon liquidation, dissolution or winding-up.

As at September 30, 2009, options to purchase 420,000 common shares of the Company issued pursuant to ProSep's stock option plan were outstanding.

The Company grants restricted share units to attract, retain and motivate key personnel and reward officers and employees for significant performance and distributable cash flow growth. Each restricted share unit is equal in value to one common share of the Company. The shares will be issued from the treasury of the Company. The number of shares reserved at any time must not exceed 10% of the aggregate number of shares.

As at September 30, 2009, 4,186,778 restricted share units were issued and outstanding.

As at September 30, 2009, warrants to purchase 27,635,027 common shares of the Company were outstanding.

Pursuant to the terms of the subscription agreement dated April 24, 2008, ProSep issued 2,036,000 common share purchase warrants at an exercise price of \$0.30 per share. As part of the private placement concluded on the same date, ProSep agreed to reduce the exercise price of the 2,424,242 warrants issued in October 2007 to Fondaction, at an exercise price from \$1.65 to \$0.55 per common share. The maturity date of the warrants has not been amended. Pursuant to the terms of the subscription agreement dated October 29, 2007, the company issued warrants to purchase 2,424,242 common shares at an exercise price of \$1.65 per common share for a period of five years to Fondaction. Pursuant to the terms of subscription agreements dated June 23, 2005, the company issued 17,000,000 units of the Company at a purchase price of \$0.50 per unit for gross proceeds of \$8,500,000, with each unit consisting of one common share of the Company and one warrant and

with each warrant being exercisable for one common share of the Company at a price of \$0.65 per common share. Such warrants were not exercised before the maturity date which was November 2nd, 2009. The broker warrants were also issued as part of this transaction of which all have been exercised. Pursuant to the terms of subscription agreements dated November 2, 2004, the company issued warrants to the FTQ, Innovatech, FIDD and BDC to purchase 4,615,385 common shares of the Company at an exercise price of \$0.65 per common share. Such warrants were not exercised before the maturity date which was November 2, 2009.

## **11. CRITICAL ACCOUNTING ESTIMATES**

Please refer to September 30 2009 consolidated financial statements as well as annual 2008 Management and discussion analysis (MD&A).

## **12. FINANCIAL DISCLOSURE**

In order to comply with the Canadian Securities Administrator's Multilateral Instrument 52-109 ("MI 52-109"), the Company has conducted an evaluation of its disclosure controls and procedures and internal controls. The implementation of MI 52-109 involves a continuous improvement process, which has brought the Company to ensure that all relevant processes and controls were documented. Refer to the previous interim and 2008 annual MD&A.

### **12.1. Disclosure controls and procedures**

Our disclosure controls and procedures are designed to provide reasonable assurance that material information required to be disclosed is recorded, processed, summarized and reported within the time periods specified under Canadian securities laws, and include controls and procedures that are designed to ensure that information is accumulated and communicated to the management committee members, including the President & CEO and the CFO, to allow timely decisions regarding required disclosure.

As of December 31, 2008, an evaluation was carried out, under the supervision of and with the participation of management, including the President & CEO, the CFO, and the Treasury Director, of the effectiveness of the disclosure controls and procedures as defined under MI 52-109. This evaluation took into consideration the Company's disclosure policy, a cascading certification process and the presence of the disclosure committee. Based on that evaluation, the President & CEO and the CFO concluded that the design and operation of our disclosure controls and procedures were effective as at December 31st, 2008.

### **12.2. Internal Control Over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance to GAAP.

Internal control over financial reporting includes policies and procedures which pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions; provide reasonable assurance that transactions are recorded as necessary, thereby permitting preparation of consolidated financial statements in accordance with determined authorizations; and

provide reasonable assurance regarding prevention or timely detection of unauthorized use of our assets that could have a material effect on our consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of our internal control over financial reporting to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies and procedures may deteriorate.

As of December 31<sup>st</sup>, 2008, management evaluated the design of internal control over financial reporting as defined under MI 52-109, and, based on that evaluation, determined that certain aspects of internal control over financial reporting were not designed effectively but were mitigated by additional procedures to compensate them. As part of the conducted evaluation, the Company has continued to implement entity level controls which are now in accordance with COSO control framework. This results in a much greater level of confidence in the mitigating controls to compensate for the identified weakness. The control deficiencies identified by the Company did not result in adjustments to our consolidated financial statements for 2008. Management's assessment identified the following material weaknesses along with related remediation:

#### **12.2.1. Entity level controls**

During the fourth quarter of 2008, The Company has ensured its entity level controls were now maintained in accordance with COSO control framework. The entity level controls have considerably evolved during the financial year, but considering that the Company went through significant changes and growth in the last years, changing considerably the environment, increasing substantially its assets and number of employees, and consequently creating a need for clear policies and procedures, there is a need for continued improvement on the control environment. We do have several written policies and procedures that are communicated and always available to employees; but some policies need to be reviewed as the business continuously evolves.

To mitigate that risk, management has been very active in:

- Communication to employees and management of their roles & responsibilities with regards to internal control over financial reporting;
- Production of bi-weekly management reports;
- Bi- weekly management committee meeting;
- Bi-weekly disclosure committee meeting (included in management committee meeting);
- Full-time availability of all policies and procedures to employees, managers, and directors;
- Evaluation of the design of the internal controls and continuous implementation of additional controls to ensure an increased level of confidence;
- Monthly financial statements are established by the corporate controller, and reviewed and analyzed by all vice-presidents and the President and CEO. With the financial statements, an analytic review is provided in order to explain variances between actual and budget.
- Quarterly financial statements are reviewed and annual financial statements are audited by external auditors. These statements, along with all related documents, are reviewed by members of the audit committee and approved by the board of directors.

As a conclusion, the Company communicated with the different consolidated subsidiaries' presidents and controllers the results of the evaluation conducted in 2008 and will proceed with implementing the required additional controls, where applicable, to ensure an even better control environment.

### **12.2.2. Segregation of duties**

The Company had deficient controls within its accounting and finance department relating to segregation of duties inherent to its size. Specifically, as a result of the limited number of personnel in the accounting and finance department, certain financial personnel had incompatible duties that allowed for the creation, review and processing of certain financial data without independent review and authorization.

To mitigate that risk, we continue to implement improved monitoring systems, other procedures to prevent occurrence of frauds, properly assign roles and responsibilities to employees to maximize segregation of duties within the limited environment, and rely on procedures and controls as described in the previous section (see 14.2.1 "Entity level controls").

It should be noted that some of the weaknesses mentioned above are related to the size of the Company and to integration of the acquired Pure Group companies during the past year. Management is nevertheless committed to establishing effective internal controls over financial reporting and as such will continue to refine existing controls and implement additional controls as deemed necessary.

## **13. SELECTED RISKS**

This section presents the most important risks associated with ProSep's business operations and is periodically reviewed by Management and overseen by the Board of Directors. During the quarter ended September 30, 2009 risks and proposed remedies and risk management practices have not materially changed. Refer to the previous 2008 annual MD&A for a complete list of risks and proposed remedies.



**Head Office:**

1155 Wellington Street  
Montreal, Quebec  
H3C 1V9 Canada  
Tel: 514-522-5550  
Fax: 514-522-2643  
www.prosepinc.com

**International Operations:**

<b>ProSep Technologies, Inc</b>	<b>ProPure AS</b>	<b>ProSep AP Sdn. Bhd.</b>
5353 W. Sam Houston Pkwy N., Ste 150 Houston, TX 77041 USA Ph: (281) 504-2040 Fax: (281) 598-2688 Toll-free: (866) 377-8788	Kokstaddalen 4 P.O. Box 106 5863 Bergen, Norway Tel: +47 55 52 94 00 Fax: +47 55 52 94 01  <b>ProPure ME SPC</b>  Trust Tower, 3rd Floor Building No.125, Road No.1702 P.O.Box 2215 Diplomatic Area, Manama Bahrain  +973 16 500 705, switchboard +973 16 500 646, office direct +973 396 48 184, mobile +973 17 532 114 telefax	(Formerly Pure Group Asia Pacific) Suite 4.12, 4th Floor Kompleks Antarabangsa Jalan Sultan Ismail 50250 Kuala Lumpur, Malaysia Tel: +603 2715 6680 Fax: +603 2715 6670

**Transfer Agent and Registrar:**

Computershare  
1500 University Street  
Montreal, Quebec  
H3A 3S8 Canada  
www.computershare.com

*ProSep Inc. is traded on the Toronto Stock Exchange under the symbol "PRP"*