Interim Financial Report
Second quarter ended
December 31, 2015

www.h2oinnovation.com
investor@h2oinnovation.com

Trading symbols:
TSX Venture: HEO
Alternext: MNEMO: ALHEO
OTCQX: HEOFF

MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE FINANCIAL SITUATION

In accordance with National Instrument 51-102 Continuous Disclosure Obligations, the following comments are intended to provide a review and an analysis of H_2O Innovation's results of operations and financial position for the quarter ended December 31, 2015, in comparison with the corresponding period ended December 31, 2014. They should be read in conjunction with the consolidated financial statements and accompanying notes. Comparison of financial situation as at December 31, 2015 to those as at June 30, 2015 is also included. Certain statements set forth in this Management's Discussion and Analysis (MD&A) regarding the operations and the activities of H_2O Innovation as well as other communications by the Corporation to the public that describe more generally management objectives, projections, estimates, expectations or forecasts may constitute forward-looking statements within the meaning of securities legislation. Forward-looking statements concern analysis and other information based on forecast future results, performance and achievements and the estimate of amounts that cannot yet be determined. Forward-looking statements include the use of the words such as "anticipate", "if", "believe", "continue", "could", "estimate", "expect", "intend", "may", "plan", "potential", "predict", "project", "should" or "will" and other similar expressions, as well as those usually used in the future and the conditional, notably regarding certain assumptions as to the success of a venture. Those forward-looking statements, based on the current expectations of management, involve a number of risks and uncertainties, known and unknown, which may result in actual and future results, performance and achievements of the Corporation to be materially different than those indicated. Information about the risk factors to which the Corporation is exposed is provided in the Annual Information Form dated September 22, 2015 available on SEDAR (www.sedar.com). Unless required to do so pursuant to applicable securities legislation, H_2O Innovation assumes no obligation to update or revise forward-looking statements contained in this Management's Discussion and Analysis or in other communications as a result of new information, future events and other changes.

The following financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS"). All figures in the present report are expressed in Canadian dollars, unless otherwise indicated.

VISION, MISSION & PROFILE

OUR VISION

To become the best in North America at providing membrane-related water treatment solutions and technologies.

OUR MISSION

To provide safe and integrated water treatment solutions and outstanding customer care in order to secure long-term relationships.

OUR PROFILE

H_2O Innovation designs and provides state-of-the-art, custom-built, and integrated water treatment solutions based on membrane filtration technology for municipal, energy and natural resources end-users. Also, directly and through its affiliates, H_2O Innovation provides services and products complementary to its membrane filtration and reverse osmosis systems. These products consist of a complete line of specialty chemicals, consumables and couplings. H_2O Innovation employs approximately 170 resources and has six locations in North America.

IMPORTANT INFORMATION

All shares, options and share purchase warrants as well as per share, option and share purchase warrant information presented in this MD&A have been adjusted, including proportionate adjustments being made to each stock option and share purchase warrant exercise price, to reflect and give effect to a consolidation, on December 1, 2014, of our issued and outstanding common shares on a five-to-one basis (the "Share Consolidation"). The Share Consolidation affected all shareholders, option holders and warrant holders uniformly and thus did not materially affect any security holder's percentage of ownership interest.

NON-IFRS FINANCIAL MEASUREMENTS

In this MD&A, the Corporation's management uses measurements that are not in accordance with IFRS. The measurements "Adjusted earnings before interest, tax depreciation and amortization (adjusted EBITDA)" and "Net debt" are not defined by IFRS and cannot be formally presented in consolidated financial statements.

The definition of adjusted EBITDA does not take into account the Corporation's finance costs – net, stock-based compensation costs, gain on purchase price adjustment, unrealized exchange loss and acquisition costs. The reader can establish the link between adjusted EBITDA and net earnings. The definition of adjusted EBITDA used by the Corporation may differ from those used by other companies.

Even though adjusted EBITDA is a non-IFRS measure, it is used by management, analysts, investors and other financial stakeholders to assess the Corporation's performance and management from a financial and operational standpoint.

Reconciliation of adjusted EBITDA to net earnings

	Three-month periods ended December 31,		**Six-month periods ended December 31,**	
	2015	2014	**2015**	2014
	$	$	**$**	$
Net earnings for the period	**174,221**	117,524	**226,550**	400,111
Finance costs – net	**216,217**	170,964	**364,254**	294,805
Income taxes	**8,000**	30,032	**212,853**	148,449
Depreciation of property, plant and equipment	**144,643**	77,227	**271,986**	153,744
Amortization of intangible assets	**236,426**	209,276	**468,105**	415,320
Gain on purchase price adjustment	**-**	-	**(375,977)**	-
Unrealized exchange loss	**203,681**	65,700	**257,087**	156,654
Acquisition costs	**47,314**	14,704	**47,418**	29,297
Stock-based compensation costs	**-**	-	**-**	2,422
Adjusted EBITDA	**1,030,502**	685,427	**1,472,276**	1,600,802

The definition of net debt consists of bank overdraft, bank loans, long-term debt less cash and cash equivalents, but excludes contingent considerations. The reader can establish the link between net debt and debt. The definition of net debt used by the Corporation may differ from those used by other companies.

Even though net debt is a non-IFRS measure, it is used by management, analysts, investors and other financial stakeholders to assess the Corporation's capital management.

	December 31, 2015	June 30, 2015
	$	$
Bank overdraft	**167,011**	2,052
Bank loans	**5,493,905**	4,432,077
Current portion of long-term debt	**911,772**	543,807
Long-term debt	**2,543,937**	499,777
Less: Cash and cash equivalents	**(1,780,287)**	(1,335,887)
Net debt	**7,336,338**	4,141,826

RESULTS OF OPERATIONS

Selected financial data
(Unaudited)

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Revenues	**13,165,590**	13,689,060	**25,424,918**	24,908,191
Gross profit before depreciation and amortization	**4,126,602**	3,171,532	**7,331,088**	6,204,483
Gross profit before depreciation and amortization	**31.3%**	23.2%	**28.8%**	24.9%
Operating expenses	**318,886**	232,817	**652,866**	433,303
Selling expenses	**1,611,384**	1,069,354	**2,969,117**	1,975,643
Administrative expenses	**1,188,169**	1,126,033	**2,231,720**	2,113,829
Research and development expenses – net	**35,610**	49,502	**120,174**	89,424
Net earnings	**174,221**	117,524	**226,550**	400,111
Basic and diluted earnings per share	**0.008**	0.006	**0.011**	0.019
Adjusted EBITDA	**1,030,502**	685,427	**1,472,276**	1,600,802

Revenues and gross profit before depreciation and amortization

Revenues for the second quarter of fiscal year 2016 totaled $13.2 M, representing a $0.5 M or 3.8% decrease, as compared with revenues of $13.7 M for the same quarter of fiscal year 2015. Even though revenues decreased from the comparable period, the ratio of adjusted EBITDA over revenues increased, from 5% for the three-month period ended December 31, 2014 to 7.8% for the comparable period ended December 31, 2015. This notable improvement of our adjusted EBITDA over revenues is fueled by the organic growth of our specialty products and services (“SP&S”) business line and the sound cost management in our water treatment projects business line. The business mix between projects and specialty products and services is allowing us to gain predictability in our business model, to secure long-term relationship with customers and to maintain high gross profit. The investments done in the past to support the growth of the Corporation are now paying off, as we are currently seeing an improvement of our gross profit generated by the operations.

Revenues from water treatment projects decreased to $5.9 M compared to $8.7 M in the corresponding period of the previous fiscal year, representing a 32.1% decrease. The decrease in revenues from water treatment projects despite the increasing backlog is due to the larger projects composing our order backlog, thus stretching the revenue recognition over a longer period of time, based on the different milestones reached. The revenues level maintained during the quarter is derived from the increase in revenues from specialty products and services (“SP&S”), which reached $7.3 M compared to $5.0 M in the comparable quarter of the previous fiscal year, representing an increase of 45.7%. This strong increase in SP&S revenues is the direct result of investments made during the last year in our operating and selling functions to support the growth of this business line. Clearlogx, which assets’ were acquired during the second quarter of fiscal year 2016, strengthened the increase in SP&S revenues. The significant weakening of the Canadian dollar compared to the US dollar also had a positive impact of $1.3 M on the level of revenues recognized during the period.

In this second quarter of fiscal year 2016, the Corporation generated a 31.3% gross profit before depreciation and amortization, a higher level than the 23.2% gross profit before depreciation and amortization generated in the second quarter of fiscal year 2015. The revenue mix in this quarter shows that revenues from SP&S represent a fair proportion of total revenues compared to the corresponding period of the previous fiscal year (55.0% in fiscal year 2016 versus 36.3% in fiscal year 2015), affecting positively our gross profit. The constant efforts deployed on improving the execution and the procurement for our water treatment projects business line is paying off, supporting the positive effect on the gross profit.

QUARTERLY SUMMARY FINANCIAL INFORMATION (unaudited)

	Three-month periods ended				Last twelve months
	December 31, 2015	**September 30, 2015**	**June 30, 2015**	**March 31, 2015**	
	$	$	$	$	$
Revenues	13,165,590	12,259,328	11,670,028	12,121,641	49,216,587
Gross profit margin	31.3%	26.1%	29.7%	32.1%	29.8%
Adjusted EBITDA	1,030,502	441,773	578,098	897,846	2,948,219
Net earnings (loss)	174,221	52,329	(284,063)	156,377	98,864
EPS basic and diluted	0.008	0.003	(0.014)	0.007	0.005
Cash flows from operating activities	128,382	(227,303)	867,972	1,392,269	2,161,321

	Three-month periods ended				Previous twelve months
	December 31, 2014	**September 30, 2014**	**June 30, 2014**	**March 31, 2014**	
	$	$	$	$	$
Revenues	13,689,060	11,219,131	7,896,401	9,826,466	42,631,058
Gross profit margin	23.2%	27.0%	26.8%	27.3%	26.1%
Adjusted EBITDA	685,427	915,370	(237,299)	391,594	1,755,092
Net earnings (loss)	117,524	282,587	(269,242)	(216,314)	(85,445)
EPS basic and diluted	0.006	0.014	(0.013)	(0.011)	(0.004)
Cash flows from operating activities	(549,922)	411,225	330,455	(298,938)	(107,180)

The significant growth of the Corporation and the scalability of the operations achieved over the past years are represented on a last twelve months period basis. Revenues for the last twelve months show an increase of 15.4% compared to the previous twelve months period, evidenced of our organic growth and constant efforts on improving our sales for all our business lines. A noticeable increase of 68.0% of the adjusted EBITDA for the last twelve months period, compared to the previous last twelve months period attests of our operational efficiency and the scalability of our business model. The results presented clearly show that quarter over quarter, we are improving profitability as revenues are growing.

The following table summarizes the evolution of the Corporation's revenues and new orders, together with the variations in its order backlog over the last six quarters. The revenues figures attest of the Corporation's vision and efforts deployed to grow revenues from specialty products and services while increasing our order backlog.

	2015 FY				2016 FY		Last twelve months	Previous twelve months
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**(Q3, Q4 FY2015 & Q1, Q2 FY2016)**	**(Q3, Q4 FY2014 & Q1, Q2 FY2015)**
Order backlog	$36.1 M	$29.6 M	$40.4 M	$36.5 M	$38.3 M	**$43.1 M**	**N/A**	N/A
Foreign exchange Impact	$1.2 M	$0.8 M	$2.2 M	$0.1 M	$1.8 M	**$1.1 M**	**N/A**	N/A
Bookings for water treatment projects (*)	$3.9 M	$1.4 M	$14.2 M	$2.8 M	$7.2 M	**$9.6 M**	**$33.8 M**	$34.4 M
Revenues from water treatment projects	$7.3 M	$8.7 M	$5.6 M	$6.9 M	$7.2 M	**$5.9 M**	**$25.6 M**	$23.8 M
Bookings / Revenues Ratio							***1.5***	***1.5***
Revenues from SP&S (usually recurrent in nature)	$3.9 M	$5.0 M	$6.5 M	$4.8 M	$5.1 M	**$7.3 M**	**$23.7 M**	$18.8 M
Total revenues	$11.2 M	$13.7 M	$12.1 M	$11.7 M	$12.3 M	**$13.2 M**	**$49.3 M**	$42.6 M

(*) Foreign exchange impact has been excluded from the bookings and reclassified separately due to the significant weakening of the Canadian currency. Previous quarters' information has been restated to reflect this new presentation for comparative purposes.

The Corporation secured $9.6 M in new bookings for water treatment projects over the quarter. These new bookings, combined with the realized revenues from water treatment projects during the quarter and the significant weakening of the Canadian dollar compared to the US dollar, have brought up the backlog at $43.1 M as at December 31, 2015 compared to $29.6 M as at December 31, 2014. This level of order backlog gives the Corporation a fairly good perspective over the coming quarters in terms of volume of revenues. Our team has demonstrated that it can manage the execution challenge that comes with such large order backlog and we have structured the organization in order to achieve even more.

The Corporation has never been exposed to so many opportunities of water treatment projects sales. In order to face this upcoming array of bidding opportunities, the Corporation has invested in SG&A expenses, which proved to be a winning move, as the order backlog reached $50.8 M as at January 6, 2016. This level of order backlog should fuel the growth of revenues in the upcoming quarters. We maintain strong bidding activities and business development in Canada and in the United States.

Operating expenses

Operating expenses have increased by $86,069 or 37.0%, totaling $0.3 M this quarter compared to $0.2 M for the corresponding quarter of previous fiscal year. This variation is partly due to the significant weakening of the Canadian dollar against the US dollar and to the addition of product development personnel and other support functions to grow the SP&S business line.

Selling expenses

Selling expenses have increased by $542,030 or 50.7%, to reach $1.6 M for this quarter compared to $1.1 M for the corresponding quarter of the previous fiscal year. Selling expenses are linked to bookings and revenues, but do not fluctuate proportionally. The increase is mostly due to the addition of sales related personnel to support the growth of revenues and sales commissions recorded in regards to sales target reached in our SP&S business line, as well the impact of the significant weakening of the Canadian dollar against the US dollar for the expenses incurred in US dollars.

Administrative expenses

Administrative expenses increased by $62,136 or 5.5%, totaling $1.2 M for this quarter compared to $1.1 M for the corresponding quarter of the previous fiscal year. The increase in administrative expenses is due to the increase in salaries and fringe benefits following the addition of personnel to support our overall operations and our expected growth as well the impact of the significant weakening of the Canadian dollar against the US dollar for the expenses incurred in US dollars.

The Corporation's ratio of selling, operating and administrative expenses ("SG&A") as a whole over revenues amounted to 23.7% for this quarter, up from 17.7% for the corresponding quarter of the previous fiscal year. This increase is mostly attributable to the additions of personnel to support our overall operations and our continuing growth. Management aims to keep the annual average SG&A ratio around 20% through a tight management of SG&A expenses and an increase in revenues.

Research and development expenses – net

For the quarter ended December 31, 2015, gross research and development expenses totaled $35,610, or 0.3% of revenues compared to $49,502 or 0.4% for the quarter ended December 31, 2014. For the three-month period ended December 31, 2015, the Corporation has not recorded tax credits from the Canadian and provincial governments for eligible research and development conducted in Canada, but intends to claim such tax credits during fiscal year 2016.

Adjusted EBITDA

Adjusted EBITDA for the quarter was recorded at $1,030,502, compared with $685,427 for the same period ended December 31, 2014, representing a ratio of 7.8% of adjusted EBITDA over revenues for this quarter compared to a ratio of 5% for the same quarter of the previous fiscal year. This significant increase in adjusted EBITDA, despite the slight decrease in revenues, demonstrates our operational efficiency and the improvement of our business model over the last year. Indeed, once the Corporation's fixed costs are covered, the gross profit will directly impact the EBITDA. Therefore, volume of revenues matters, as well as a sound cost management.

Other losses / (gains) – net

Other losses / (gains) – net amounting to $193,046 for the period ended December 31, 2015 compared with $88,803 for the quarter ended December 31, 2014 are mostly composed of unrealized and realized exchange losses and (gains) of $203,682 and ($6,479) respectively, as at December 31, 2015. The unrealized and realized exchange losses for the comparable period of fiscal year 2015 were, respectively $65,700 and $34,829.

Finance costs – net

Finance costs – net totalled $216,217 for the period ended December 31, 2015 compared to $170,964 for the comparable period in the previous fiscal year. The variation of the finance costs relates mostly to the increased use of the bank loans to support the continuing growth of our operations. Of this amount, $8,530 represents the theoretical and non-monetary part of interest on long-term debt. In order to mitigate its credit risk, the Corporation started to insure a part of its accounts receivables through the insurance program of Exportation and Development Canada ("EDC") in August 2014. This insurance program allows under certain conditions, an insurance coverage that can reach an amount equivalent to 90% of the receivables. As at December 31, 2015, the EDC insurance coverage represents approximately 59% of the receivables (63% as at June 30, 2015). The Corporation has given direction to pay all insurance proceeds to the bank since the insurance coverage allows the Corporation to increase its bank loans usage capacity.

Net earnings

The net earnings amounted to $174,221 or $0.008 per share for the second quarter of fiscal 2016 compared with $117,524 or $0.006 per share for the second quarter of fiscal 2015. The increase in net earnings is the result of an improved level of gross profit before depreciation and amortization.

Commitments

The Corporation has entered into long-term lease agreements expiring between 2017 and 2024, which call for lease payments of $5,358,561 for the rental of space. The minimum annual lease payments over the next five years are $908,765 in 2016, $831,707 in 2017, $714,839 in 2018, $710,862 in 2019 and $697,045 in 2020.

Information on share capital

As at December 31, 2015, the Corporation had 20,926,551 outstanding shares and 284,000 stock options.

FINANCIAL SITUATION

Working capital increased from $8.4 M as at June 30, 2015 (working capital ratio of 1.75) to $9.0 M as at December 31, 2015 (working capital ratio of 1.54). The increase of $0.6 M is attributable to the $1.0 M, $1.6 M and $3.4 M increase in accounts receivable, inventories and costs incurred in excess of billings respectively, and by the increase of $4.0 M, $1.1 M and $0.4 M in accounts payable and accrued liabilities, bank loans as well as current portion of long-term debt respectively.

The net debt which stood at $7.3 M as at December 31, 2015 increased by $3.2 M compared with $4.1 M as at June 30, 2015. This increase is attributable to the increase of the bank loans and to the new long-term debt of $2.7 M (US$2 M) contracted for the acquisition of Clearlogx' assets during the second quarter of fiscal year 2016.

Equity stood at $28.4 M as at December 31, 2015, compared with $26.0 M as at June 30, 2015. As at December 31, 2015, the net debt to equity ratio was 0.26, compared with 0.16 as at June 30, 2015, showing that the Corporation is not over leveraged.

(in Canadian dollars, except for ratios)	**Period ended December 31, 2015**	**Period ended June 30, 2015**
Working capital	$9,039,049	$8,423,583
Working capital ratio	1.54	1.75
Net debt[1]	$7,336,338	$4,141,826
Equity	$28,405,661	$26,007,486
Net debt to equity ratio	0.26	0.16

[1] Net debt comprises bank overdraft, bank loans and the long-term debt, net of cash and cash equivalents, but excludes contingent consideration.

As at December 31, 2015 accounts receivable stood at $10.9 M compared with $9.9 M as at June 30, 2015. The rise of $1.0 M is mostly attributable to the increase of accounts receivable from customers under manufacturing contracts related to water treatment projects executed during the second quarter of fiscal year 2016 and to the significant sales in our SP&S business line near the end of the second quarter.

Inventories increased by $1.6 M to $5.5 M as at December 31, 2015 compared with $4.0 M as at June 30, 2015. Inventories have increased due to finished goods manufactured during the summer in preparation for the start of the maple syrup production season. In addition, finished goods have also increased due to the large order of Piedmont's couplings to be delivered in the third quarter of fiscal year 2016.

Costs incurred in excess of billings increased by $3.4 M to $5.5 M as at December 31, 2015, from $2.1 M as at June 30, 2015, primarily due to a greater number of active projects for which there are differences between project advancement and project invoicing schedules. Billings in excess of costs incurred were somewhat stable, decreasing to $1.3 M as at December 31, 2015, from $1.4 M as at June 30, 2015. This decrease is also attributable to differences between project advancement and project invoicing schedules.

Accounts payable and accrued liabilities increased by $4.0 M to $8.7 M as at December 31, 2015, from $4.7 M as at June 30, 2015. This is mostly due to the volume of activities for water treatment projects which have reached, for many of them, the manufacturing stage during which equipment are being assembled and for which suppliers are involved. In addition, the accounts payable and accrued liabilities are impacted by the significant weakening of the Canadian dollar against the US dollar for the expenses incurred in US dollars.

The increase in the current portion of the long-term debt is explained by the new debt contracted, subdued by the repayment of $0.2 M during the quarter. For the second quarter ended December 31, 2015, shareholders' equity increased by $2.4 M to $28.4 M ($26.0 M as at June 30, 2015). The following elements had an impact on shareholders' equity in the second quarter of fiscal year 2016: 1) the $226,550 net earnings for the six-month period ended December 31, 2015 and 2) the Canadian dollar's depreciation which generated an unrealized exchange gain of $2.2 M resulting from the translation of foreign operations, mainly those of the U.S. subsidiaries.

CASH FLOWS

A comparison of the Corporation's cash flows for the periods ended December 31, 2015 and 2014 is presented below:

(in Canadian dollars) (unaudited)	**Three-month period ended December 31, 2015**	Three-month period ended December 31, 2014	**Six-month period ended December 31, 2015**	Six-month period ended December 31, 2014
	$	$	**$**	$
Cash flows from operating activities	**128,382**	(549,922)	**(98,921)**	(138,696)
Cash flows from investing activities	**(2,811,721)**	(363,759)	**(2,703,267)**	(468,243)
Cash flows from financing activities	**2,711,028**	956,283	**2,948,362**	246,509
Effect of exchange rate changes on the balance of cash held in foreign currencies	**47,639**	42,034	**133,267**	73,064
Net change	**75,328**	84,636	**279,441**	(287,366)
Cash and cash equivalents – Beginning of period	**1,537,948**	12,367	**1,333,835**	384,369
Cash and cash equivalents – End of period	**1,613,276**	97,003	**1,613,276**	97,003

Operating activities generated $128,382 in cash for the three-month period ended December 31, 2015, compared with ($549,922) of cash used during the corresponding period ended December 31, 2014. The variation is mainly attributable to the change in working capital items and the unrealized exchange loss on the long-term debt contracted during the period.

For the second quarter of fiscal year 2016, investing activities used net cash of ($2,811,721), compared with ($363,759) of cash used during the corresponding period ended December 31, 2014. The variation is mainly attributable to the acquisition of Clearlogx's assets for $2.0 M, the investment of $0.2 M in a new enterprise resources planning (ERP) software and by the investment of $0.5 M in new pilot units for our water treatment projects business line.

Financing activities generated net cash of $2,711,028 in the second quarter of fiscal 2016 compared with $956,283 of net cash generated during the corresponding period ended December 31, 2014. The variation is mainly attributable to the new long-term debt of $2.6 M contracted during the quarter, but subdued by the reimbursement of $230,132 of the Corporation's long-term debt. Interest paid during the second quarter of fiscal year 2016 amounted to $216,109.

CAPITAL MANAGEMENT

The Corporation's objective in managing capital is to ensure sufficient liquidity to pursue its growth while at the same time taking a prudent approach towards financial leverage and financial risk.

The Corporation's capital is composed of net debt and shareholders' equity. Net debt consists of bank overdraft, bank loans, long-term debt less cash and cash equivalents, but excludes contingent considerations. The Corporation's primary uses of capital are to finance increases in non-cash working capital and capital expenditures for capacity expansion and integration.

The Corporation monitors its performance through different ratios such as those required under its credit facility and long-term debt arrangements.

Credit facility and long-term debt arrangements require that the Corporation meet certain annual financial ratios at fixed points in time. The financial ratios are, as at December 31, 2015:

- Working capital ratio, defined as current assets divided by current liabilities greater than or equal to 1.25:1.00;
- Debt-to-equity ratio, defined as total debt excluding deferred taxes divided by equity of less than or equal to 2.00:1.00; and
- Fixed charge coverage ratio, including all capital and interest payments on borrowings due and capital expenditures, as defined, greater than or equal to 1.00:1.00.

As at June 30, 2015, the Corporation was in compliance with its annual financial ratios required for its credit facility and long-term debt arrangements.

ACCOUNTING POLICIES

The reader is invited to refer to the summary of significant accounting policies presented in note 3 to the consolidated financial statements as at June 30, 2015.

OFF-BALANCE SHEET ARRANGEMENTS

As at December 31, 2015, the Corporation had off-balance sheet arrangements consisting of letters of credit amounting to $1.6 M; which expire at various dates through fiscal year 2017. In these letters of credit, $1.2 M is secured by deposit certificates.

CONTROLS AND PROCEDURES

In compliance with the Canadian Securities Administrators' National Instrument 52-109 ("NI 52-109"), the Corporation has filed certificates signed by the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO") that, among other things, report on the design and effectiveness of disclosure controls and procedures and the design and effectiveness of internal controls over financial reporting.

Disclosure controls and procedures

The CEO and the CFO have designed disclosure controls and procedures, or have caused them to be designed under their supervision, in order to provide reasonable assurance that:

- material information relating to the Corporation has been made known to them; and
- information required to be disclosed in the Corporation's filings is recorded, processed, summarized and reported within the time periods specified in securities legislation.

An evaluation was carried out, under the supervision of the CEO and the CFO, of the effectiveness of our disclosure controls and procedures. Based on this evaluation, the CEO and the CFO concluded that the disclosure controls and procedures are effective, using the criteria set forth in National Instrument 52-109.

Internal controls over financial reporting

The CEO and the CFO have also designed internal controls over financial reporting, or have caused them to be designed under their supervision, in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS. The internal controls over financial reporting are designed using the criteria set forth by the *Committee of Sponsoring Organizations of the Treadway Commission 2013* (COSO 2013) on Internal Control – Integrated Framework. The work performed allows us to conclude that the internal controls over financial reporting are effective for the period ended December 31, 2015.

Changes in internal controls over financial reporting

During the quarter, the Corporation did not make any modifications to the internal controls over financial reporting that had or could reasonably be expected to have a significant impact on the internal controls over financial reporting.



CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Second quarter ended
December 31, 2015

The condensed interim consolidated financial statements which are included in this report have not been subject to a review by the Corporation's external auditors.

For additional information:
Investor Relations
investor@h2oinnovation.com

Trading symbols:

TSX Venture: HEO
Alternext: MNEMO: ALHEO
OTCQX: HEOFF

Financial reports, annual reports and press releases are accessible on our website:
www.h2oinnovation.com and on SEDAR.

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (Unaudited)

	December 31, 2015	June 30, 2015
	$	$
ASSETS		
Current assets		
Cash and cash equivalents	**1,780,287**	1,335,887
Guaranteed deposit certificates	**1,581,852**	1,629,803
Accounts receivable (note 4)	**10,884,536**	9,876,150
Inventories (note 5)	**5,520,474**	3,955,411
Costs incurred in excess of billings	**5,516,325**	2,096,403
Prepaid expenses	**514,342**	753,766
	25,797,816	19,647,420
Non-current assets		
Property, plant and equipment	**3,538,506**	3,020,789
Intangible assets (note 3)	**10,537,880**	7,592,573
Other assets	**75,628**	60,515
Goodwill (note 3)	**5,201,541**	4,694,166
Deferred income tax assets	**2,939,952**	2,832,159
	48,091,323	37,847,622
LIABILITIES		
Current liabilities		
Bank overdraft	**167,011**	2,052
Bank loans (note 6)	**5,493,905**	4,432,077
Accounts payable and accrued liabilities (note 7)	**8,707,059**	4,729,427
Provisions (note 8)	**101,994**	84,272
Billings in excess of costs incurred	**1,343,994**	1,409,396
Income taxes payable	**23,753**	14,908
Deferred rent	**9,279**	7,898
Current portion of long-term debt (notes 3 and 9)	**911,772**	543,807
	16,758,767	11,223,837
Non-current liabilities		
Long-term debt (notes 3 and 9)	**2,543,937**	499,777
Deferred rent	**117,086**	116,522
Contingent consideration (note 3)	**265,872**	-
	19,685,662	11,840,136
SHAREHOLDERS' EQUITY		
Share capital (note 10)	**55,298,945**	55,298,945
Reserve - Stock options	**1,876,379**	1,876,379
Deficit	**(33,100,862)**	(33,327,412)
Accumulated other comprehensive income	**4,331,199**	2,159,574
	28,405,661	26,007,486
	48,091,323	37,847,622

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

On behalf of the Board,

Frédéric Dugré



President and Chief Executive Officer

Philippe Gervais



Chairman of the Board of Directors

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
For the six-month periods ended December 31, 2015 and 2014
(Unaudited)

	ATTRIBUTABLE TO THE SHAREHOLDERS OF H_2O INNOVATION INC.					
			Reserves			
	Common shares Number (note 12)	**Share capital** (note 10)	**Stock option** (note 10)	**Deficit**	**Accumulated other comprehensive income – Translation adjustment**	**Total**
		$	**$**	**$**	**$**	**$**
Balance as at July 1, 2014	20,926,551	55,298,945	1,873,957	(33,599,837)	(1,012,182)	22,560,883
Stock-based compensation costs	-	-	2,422	-	-	2,422
Net earnings for the period	-	-	-	400,111	-	400,111
Other comprehensive income – Currency translation adjustments	-	-	-	-	1,674,248	1,674,248
Balance as at December 31, 2014	20,926,551	55,298,945	1,876,379	(33,199,726)	662,066	24,637,664
Balance as at July 1, 2015	20,926,551	55,298,945	1,876,379	(33,327,412)	2,159,574	**26,007,486**
Net earnings for the period	-	-	-	226,550	-	**226,550**
Other comprehensive income – Currency translation adjustments	-	-	-	-	2,171,625	**2,171,625**
Balance as at December 31, 2015	**20,926,551**	**55,298,945**	**1,876,379**	**(33,100,862)**	**4,331,199**	**28,405,661**

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF EARNINGS
For the three-month and six-month periods ended December 31, 2015 and 2014
(Unaudited)

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Revenues (note 14)	**13,165,590**	13,689,060	**25,424,918**	24,908,191
Cost of goods sold (note 11 a))	**9,038,988**	10,517,528	**18,093,830**	18,703,708
Gross profit before depreciation and amortization	**4,126,602**	3,171,532	**7,331,088**	6,204,483
Operating expenses (note 11 a))	**318,886**	232,817	**652,866**	433,303
Selling expenses (note 11 a))	**1,611,384**	1,069,354	**2,969,117**	1,975,643
Administrative expenses (note 11 a))	**1,188,169**	1,126,033	**2,231,720**	2,113,829
Research and development expenses – net (notes 11 a) and c))	**35,610**	49,502	**120,174**	89,424
Depreciation of property, plant and equipment (note 11 b))	**144,643**	77,227	**271,986**	153,744
Amortization of intangible assets (note 11 b))	**236,426**	209,276	**468,105**	415,320
Other losses (gains) – net (note 11 d))	**193,046**	88,803	**(186,537)**	179,855
Operating costs total	**3,728,164**	2,853,012	**6,527,431**	5,361,118
Operating earnings	**398,438**	318,520	**803,657**	843,365
Finance income	**(3,568)**	(3,401)	**(7,195)**	(6,074)
Finance costs	**219,785**	174,365	**371,449**	300,879
Finance costs – net	**216,217**	170,964	**364,254**	294,805
Earnings before income taxes	**182,221**	147,556	**439,403**	548,560
Current income tax expense	**26,749**	42,787	**249,979**	176,494
Deferred tax benefit	**(18,749)**	(12,755)	**(37,126)**	(28,045)
	8,000	30,032	**212,853**	148,449
Net earnings for the period attributable to shareholders	**174,221**	117,524	**226,550**	400,111
Net earnings per share attributable to the equity holders of the company during the period				
Basic and diluted net earnings per share (note 12)	**0.008**	0.006	**0.011**	0.019
Weighted average number of shares outstanding (note 12)	**20,926,551**	20,926,551	**20,926,551**	20,926,551

The accompanying notes are an integral part of the condensed interim consolidated financial statements.

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the three-month and six-month periods ended December 31, 2015 and 2014
(Unaudited)

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Net earnings for the period	**174,221**	117,524	**226,550**	400,111
Other comprehensive income – Items that may be reclassified subsequently to net earnings				
Currency translation adjustments	**854,658**	704,786	**2,171,625**	1,674,248
Comprehensive income for the period	**1,028,879**	822,310	**2,398,175**	2,074,359

These accompanying notes are an integral part of these condensed interim consolidated financial statements.

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS
For the three-month and six-month periods ended December 31, 2015 and 2014
(Unaudited)

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Cash flows from operating activities				
Earnings before income taxes for the period	**182,221**	147,556	**439,403**	548,560
Non-cash items				
Finance costs – net	**216,217**	170,964	**364,254**	294,805
Depreciation of property, plant and equipment	**144,643**	77,227	**271,986**	153,744
Amortization of intangible assets	**236,426**	209,276	**468,105**	415,320
Gain on purchase price adjustment (note 11 d))	**-**	-	**(375,977)**	-
Unrealized exchange loss on long-term debt	**148,869**	-	**148,869**	-
Deferred rent	**(2,490)**	378	**(4,969)**	696
Stock-based compensation	**-**	-	**-**	2,422
	925,886	605,401	**1,311,671**	1,415,547
Change in working capital items (notes 13 a))	**(782,259)**	(1,158,354)	**(1,398,974)**	(1,542,680)
Cash generated by (used in) operations	**143,627**	(552,953)	**(87,303)**	(127,133)
Interests received	**3,568**	3,401	**7,195**	6,074
Income taxes paid	**(18,813)**	(370)	**(18,813)**	(17,637)
Net cash generated by (used in) operating activities	**128,382**	(549,922)	**(98,921)**	(138,696)
Cash flows from investing activities				
Variation of guaranteed deposits certificates	**(2,426)**	(41)	**58,421**	(1,162)
Payment received on purchase price adjustment (note 11 d))	**-**	-	**375,977**	-
Acquisition of property, plant and equipment	**(547,991)**	(341,220)	**(718,747)**	(383,609)
Acquisition of intangible assets	**(274,763)**	(22,498)	**(432,377)**	(83,472)
Variation of other assets	**(10,291)**	-	**(10,291)**	-
Assets acquired through business combination (note 3)	**(1,976,250)**	-	**(1,976,250)**	-
Net cash used in investing activities	**(2,811,721)**	(363,759)	**(2,703,267)**	(468,243)
Cash flows from financing activities				
Variation of bank loans	**542,269**	1,243,051	**1,061,828**	897,238
Long-term debt reimbursement	**(230,132)**	(213,455)	**(365,548)**	(468,267)
Long-term debt contracted	**2,615,000**	90,200	**2,615,000**	90,200
Interest paid	**(216,109)**	(163,513)	**(362,918)**	(272,662)
Net cash generated by financing activities	**2,711,028**	956,283	**2,948,362**	246,509
Net change in cash and cash equivalents	**27,689**	42,602	**146,174**	(360,430)
Effect of exchange rate changes on the balance of cash held in foreign currencies	**47,639**	42,034	**133,267**	73,064
Increase (decrease) in cash and cash equivalents	**75,328**	84,636	**279,441**	(287,366)
Cash and cash equivalents - Beginning of period (note 12 b))	**1,537,948**	12,367	**1,333,835**	384,369
Cash and cash equivalents - End of period (note 12 b))	**1,613,276**	97,003	**1,613,276**	97,003

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Description of Business

H_2O Innovation Inc. (the "Corporation") is incorporated under the *Canada Business Corporations Act*. The Corporation designs and provides state-of-the-art, custom-built, and integrated water treatment solutions based on membrane filtration technology for municipal, energy and natural resources end-users. Also, directly and through its affiliates, H_2O Innovation provides services and products complementary to its membrane filtration and reverse osmosis systems. These products consist of a complete line of specialty chemicals, consumables and couplings. At the same time and on a smaller scale, the Corporation continues its manufacturing and equipment distribution operations for the maple industry. The head office of the Corporation is located at 330 Saint-Vallier Street East, suite 340, Quebec City (Quebec), Canada.

2. Basis of Preparation

Basis of preparation

The Corporation's financial statements are presented in Canadian dollars. All values are rounded at the nearest dollar, except otherwise indicated.

These condensed interim consolidated financial statements have been prepared in accordance with IAS 34, Interim Financial Reporting ("IAS 34").

The IFRS accounting policies that are set out in the Corporation's consolidated financial statements for the year ended June 30, 2015 were consistently applied to all periods presented. Please refer to note 3 in the Corporation's consolidated financial statements for the year ended June 30, 2015 for a complete description of the Corporation's significant accounting policies.

The preparation of financial statements in conformity with IAS 34 requires the use of certain critical accounting estimates. It also requires management to exercise judgment in the process of applying the Corporation's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant are disclosed in note 4 in the Corporation's consolidated financial statements for the year ended June 30, 2015 and remained unchanged for the six-month period ended December 31, 2015.

The accompanying unaudited condensed interim consolidated financial statements were prepared on a going concern basis, under the historical cost convention.

These condensed interim consolidated financial statements are intended to provide an update on 2015 annual statements. Accordingly they do not include all the information required for annual financial statements and should be read in conjunction with the Corporation's 2015 annual audited consolidated financial statements.

On February 5, 2016 the Board reviewed the accompanying condensed interim consolidated financial statements and authorized its publication.

Standards and interpretations issued to be adopted at a later date

The following revised standards are effective for annual periods beginning on or after January 1, 2018 for IFRS 9 and January 1, 2017 for IFRS 15, with earlier application permitted. On July 22, 2015, the IASB has confirmed a one-year deferral of the effective date of IFRS 15 to January 1, 2018. The Corporation has not yet assessed the impact of these standards and amendment on its unaudited consolidated financial statements or determined whether it will early adopt them.

IFRS 9, *Financial Instruments*, was issued in November 2009 and addresses classification and measurement of financial assets. It replaces the multiple category and measurement models in IAS 39, *Financial Instruments: Recognition and Measurement* with a single approach to determine whether a financial asset is measured at amortized cost, fair value through other comprehensive income or fair value through the statement of income (loss).

IFRS 9 also replaces the models for measuring equity instruments. Such instruments are either recognized at fair value through the statement of income (loss) or at fair value through other comprehensive income. Where equity instruments are measured at fair value through other comprehensive income, dividends are recognized in the statement of income (loss) to the extent that they do not clearly represent a return of investment; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely.

Requirements for financial liabilities were added to IFRS 9 in October 2010 and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss are generally recorded in other comprehensive income.

In May 2014, the IASB released IFRS 15, *Revenue from Contracts with Customers*, which establishes principles for reporting the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. It provides a single model in order to depict the transfer of promised goods or services to customers. The core principle of IFRS 15 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods and services. IFRS 15 also requires more comprehensive disclosures about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers.

IFRS 15 supersedes IAS 11, *Construction Contracts*, IAS 18, *Revenue*, and a number of revenue-related interpretations (IFRIC 13, *Customer Loyalty Programmes*, IFRIC 15, *Agreements for the Construction of Real Estate*, IFRIC 18, *Transfers of Assets from Customers*, and SIC-31, *Revenue, Barter Transactions Involving Advertising Service*). IFRS 15 is effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted.

3. Business Combination

Description of the business combination

On October 21, 2015, the Corporation acquired all of the assets of Clearlogx pertaining to its unique Clearlogx® control technology and its specialty coagulant. In addition to the Clearlogx® technology, the Corporation purchased Clearlogx's business related to the sale of coagulants for conventional and membrane filtration systems. This acquisition was made for a total consideration of $ 1.97 million (US$1.5 million), with potential earn-out payments over a period of three (3) years following the effective date of the transaction. The acquisition of these assets was accounted for using the purchase method. The assets results have been consolidated as of October 21, 2015. This acquisition was entirely financed with a long-term bank loan of $ 2.63 million (US$2 million) borrowed from BMO Bank and secured at 75% by EDC, allowing the Corporation to reduce its interest rate.

Assets acquired at the acquisition date

	October 21, 2015 $
Assets	
Non-current assets	
Property, plant and equipment	
Machinery and equipment	**9,221**
Intangible assets	
Customer backlog	**33,841**
Client relationships	**433,125**
Intellectual property	**1,650,935**
Trademark	**114,750**
Total	**2,241,872**
Identifiable net assets acquired	**2,241,872**

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

The purchase price allocation shown above is preliminary and based on management best estimates as at December 31, 2015. The final purchase price allocation is expected to be completed as soon as management has gathered all of the significant information available and considered necessary in order to finalize this allocation especially in regards to intangible assets.

In the intangible assets' tax treatment, 75% of the intangible assets acquired will be treated as eligible assets with related tax deductions and 25% as non-deductible.

Sources and uses of funds at the transaction closing date

	October 21, 2015 $
Sources	
Bank loan (note 9)	**2,634,600**
	2,634,600
Uses	
Cash consideration transferred	**(1,976,000)**
Working capital for the Company's current activities	**(392,728)**
Contingent consideration	**(265,872)**
	-

The contingent consideration was estimated based on certain forecasted revenues and determined EBITDA over a three year period.

Costs related to the acquisition

The total acquisition-related costs amounted to $47,418 and are included in administrative expenses in the Condensed Interim Consolidated Statement of earnings.

Determination of fair value

At the acquisition date, the identifiable assets acquired are recognized at the acquisition-date fair value.

The Company's valuation of intangible assets has identified customer backlog, client relationships, intellectual property and trademark. The assigned useful lives are 3.5 months for customer backlog, 10 years for client relationships, 10 years for intellectual property and undefined for trademark. Significant assumptions used in the determination of intangible assets, as defined by management, are year-over-year sales growth, discount rate and operating income before depreciation and amortization margin.

Goodwill arising from the business combination

Based on management's preliminary calculations, no goodwill has been attributed to the transaction. These estimates are subject to change or revaluation by management.

Impact of the business combination on the Company's financial performance

The Company's earnings for the three months and six months period ended December 31, 2015 includes $120,679 in revenues and a $6,070 profit generated from Clearlogx additional business.

If the business combination had been completed on July 1, 2015, the Company's consolidated revenues for the three months period ended December 31, 2015 would have totalled $13,256,210 and consolidated earnings for the three months period ended December 31, 2015 would have been $175,174. For the six months period ended December 31, 2015, consolidated revenues would have reached $25,789,323, while the consolidated earnings for the same period would have been $250,181.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

The Company considers the pro forma figures to be an approximate measurement of the financial performance of the combined business over a three-month and six-month period. However, pro forma information does not account for synergies or changes to historical transactions and is not necessarily indicative of the profit of the Company if the acquisition actually occurred on July 1, 2015, nor the profit that may be achieved in the future.

To determine the Company's pro forma consolidated revenues and profit if Clearlogx had been acquired on July 1, 2015, the Company:

- Calculated depreciation of property, plant and equipment and amortization of other acquired intangible assets based on the fair value arising from initial recognition of the business combination rather than the carrying amounts recognized in the pre-acquisition financial statements.
- Calculated the borrowing costs on the Company's net indebtedness after the business combination.
- Calculated an additional income tax expense to reflect the pro forma adjustments described above.

4. Accounts Receivable

	As at December 31, 2015	As at June 30, 2015
	$	$
Trade accounts receivable	**9,163,695**	8,348,130
Retentions from customers under manufacturing contracts	**807,632**	1,018,469
Allowance for doubtful accounts	**(16,014)**	(1,270)
	9,955,313	9,365,329
Tax credits receivable	**93,539**	99,885
Other receivables	**835,684**	410,936
	10,884,536	9,876,150

In order to mitigate its credit risk, the Corporation started to insure a part of its accounts receivable through the insurance program of Exportation and Development Canada ("EDC") in August 2014. This insurance program allows under certain conditions, an insurance coverage that can reach an amount equivalent to 90% of the receivables. As at December 31, 2015, the EDC insurance coverage represents approximately 59% of the receivables (63% as at June 30, 2015).

The Corporation has given direction to pay all insurance proceeds to the bank since the insurance coverage allows the Corporation to increase its bank loans usage capacity.

5. Inventories

	As at December 31, 2015	As at June 30, 2015
	$	$
Raw materials	**1,248,852**	1,040,487
Finished goods	**4,271,622**	2,914,924
	5,520,474	3,955,411

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

6. Bank loans

The bank loans for an authorized amount of $5,000,000 or US$5,000,000 ($6,920,000) bearing interest at CDN prime rate plus 1.00% (3.70% as at December 31, 2015 and June 30, 2015) and at US prime rate plus 1.00% (5.00% as at December 31, 2015 and 4.75% as at June 30, 2015) are secured by an assignment of accounts receivable and inventories and by Export Development Canada ("EDC"). As at December 31, 2015, $5,470,574 was used on this line of credit ($4,432,077 as at June 30, 2015).

The Corporation has an authorized credit facility available of $2,000,000 or US$2,000,000 ($2,768,000) bearing interest at CDN prime rate plus 1.00% (3.70% as at December 31, 2015 and June 30, 2015) and at US prime rate plus 1.00% (5.00% as at December 31, 2015 and 4.75% as at June 30, 2015). This credit facility is secured by EDC. As at December 31, 2015, $438,531 was used on this credit facility (unused as at June 30, 2015).

The Corporation has a credit facility enabling it to issue letters of credit for a maximum amount of $1,000,000. This credit facility is secured either by EDC or guaranteed deposit certificate. As at December 31, 2015, $357,760 was used on this credit facility (unused as at June 30, 2015).

The Corporation has a credit facility enabling it to issue letters of credit for a maximum amount of $1,000,000. The credit facility is secured by $1,005,573 in guaranteed deposit certificate ($1,001,036 as at June 30, 2015). As at December 31, 2015, the Corporation issued $1,000,000 in letters of credit under this credit facility ($1,000,000 as at June 30, 2015).

The Corporation has access to hedging facility of $500,000. This facility is secured by EDC and is unused as at December 31, 2015 (unused as at June 30, 2015).

The Corporation has a credit facility enabling it to use a maximum amount of $400,000 on credit cards for Corporation's related expenses. This credit facility is secured by $251,523 in guaranteed deposit certificate ($250,388 as at June 30, 2015).

The Corporation has a letter of credit amounting to $69,958 ($62,450 as at June 30, 2015) which is secured by a $69,200 guaranteed deposit certificate ($62,450 as at June 30, 2015).

The Corporation still has letters of credit amounting to $122,581 with its previous bank, which are secured by a $133,135 guaranteed deposit certificate ($132,727 as at June 30, 2015).

Covenants

The Corporation has undertaken to maintain covenants on a yearly basis in respect of the bank loans described above.

7. Accounts Payable and Accrued Liabilities

	As at December 31, 2015	As at June 30, 2015
	$	$
Trade accounts payable	**3,526,844**	3,039,313
Other accrued liabilities and accounts payable	**5,180,215**	1,690,114
	8,707,059	4,729,427

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

8. Provisions

The change in carrying value of the provision for warranties is as follows:

	$
Balance as at June 30, 2014	77,391
Additional provisions recognised	12,000
Less: Payments	(16,273)
Effect of foreign exchange differences	11,154
Balance as at June 30, 2015	84,272
Additional provisions recognised	**17,500**
Less: Payments	**(12,338)**
Effect of foreign exchange differences	**12,560**
Balance as at December 31, 2015	**101,994**

9. Long-Term Debt

	As at December 31, 2015	As at June 30, 2015
	$	$
Unsecured – at amortised cost		
Bank loan, denominated in US dollars (a)	**2,675,733**	-
Bank loan, denominated in Canadian dollars (b)	**445,440**	460,000
Loan from other entities, denominated in Canadian dollars (c)	**287,729**	529,199
Loan from other entities, denominated in US dollars (d)	**46,807**	54,385
	3,455,709	1,043,584
Less : Current portion	**911,772**	543,807
Long-term debt	**2,543,937**	499,777

(a) Bank loan
On October 20, 2015, an agreement was concluded for a loan amounting to $2,768,000 (US$ 2,000,000), to finance the acquisition of all the assets of Clearlogx' control technology and its specialty coagulant. The loan bears interest at prime rate plus 1.0% (3.7% as at December 31, 2015), payable in 60 monthly instalments of $46,133 (US$33,333), principal only, maturing on October 20, 2020.

(b) Bank loan
On September 20, 2014, an agreement was concluded for a loan amounting up to $460,000, secured by a first rank hypothec on the Ham-Nord plant, representing a carrying value of $1,300,000, bearing interest at prime rate plus 1.05% (5.75% as at December 31, 2015), payable in one instalment of $4,120 on September 23, 2015 and 131 monthly instalments of $3,480, principal only, maturing on August 23, 2026.

(c) Loan from other entities
The loan of $287,729 bearing interest at 12% (effective rate of 17.5%) is repayable in monthly instalments maturing July 1, 2016.

On August 28, 2014, an agreement was concluded giving a six-month moratorium option the repayment of principal with an increase of 0.25% of the interest rate applicable. On October 20, 2014, the Corporation has exercised its six-month moratorium option on the repayment of principal starting November 1, 2014.

(d) Loans from other entities
A loan of $46,807 (US$ 33,821), bearing interest at 8.5% payable in monthly instalments of $2,630 (US$ 1,900) and maturing July 1, 2017.

10. Capital Stock

Share consolidation (reverse stock split)

On December 1st, 2014, the Corporation effected a consolidation of its issued and outstanding common shares on a five-to-one basis (the "Share Consolidation"). The Share Consolidation affected all shareholders, optionholders and warrantholders uniformly and thus did not materially affect any securityholder's percentage of ownership interest. All references in these consolidated financial statements to common shares, options and share purchase warrants have been retroactively adjusted to reflect the Share Consolidation.

The 104,632,977 common shares issued and outstanding immediately prior to the Share Consolidation were consolidated into 20,926,551 common shares. The Corporation's outstanding stock options and share purchase warrants were adjusted on the same basis with proportionate adjustments being made to each stock option and share purchase warrant exercise price.

All share, option and share purchase warrant and per share, option and share purchase warrant data have been retroactively adjusted to reflect and give effect to the Share Consolidation as if it occurred at the beginning of the earliest period presented.

Stock options

The Corporation has established a stock option plan whereby the Board of Directors may grant stock options to directors, executive officers, key employees and consultants providing services to the Corporation. The Board of Directors determines, at its discretion, the vesting terms, if applicable, the expiry date of options and the number of options to be granted. The maximum number of shares that may be issued under the plan amounts to 1,100,000.

The following table summarizes the activity under the Corporation’s stock-based compensation plan.

	Six-month period ended December 31, 2015		Year ended June 30, 2015	
	Number	**Weighted average exercise price**	Number	Weighted average exercise price
		$		$
Outstanding - Beginning of period	**331,500**	**2.64**	347,500	2.66
Forfeited	**(47,500)**	**2.71**	(16,000)	3.13
Outstanding - End of period	**284,000**	**2.63**	331,500	2.64

11. Additional information about the nature of costs components

a) Expenses by nature

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Material	**6,760,407**	7,029,929	**12,588,527**	12,287,539
Changes in inventories of raw material, finished goods and costs incurred in excess of billings	**(69,070)**	(588,473)	**952,190**	(24,859)
Salaries and fringe benefits	**3,774,782**	3,102,514	**7,016,193**	5,843,855
Subcontractors and professional fees	**500,357**	1,991,979	**930,818**	2,672,671
Rent, electricity , insurance and office expenses	**483,516**	461,353	**959,692**	845,688
Telecommunications and travel expenses	**496,602**	492,595	**953,706**	811,795
Bad debt expenses	**102,738**	51,240	**118,752**	81,240
Other expenses	**143,705**	454,097	**547,829**	797,978
Total cost of goods sold, operating, selling, administrative and research and development expenses	**12,193,037**	12,995,234	**24,067,707**	23,315,907

b) Depreciation and amortization

The Corporation has elected to present depreciation and amortization as a separate line item in its condensed interim consolidated statement of earnings, as opposed to reflecting the fraction of such amount that pertains to each of the cost of goods sold, operating expenses, selling expenses, administrative expenses and research and development expenses – net, within those cost categories. The following tables provide: i) a breakdown of the depreciation and amortization expense by cost category as noted above, for the three-month and six-month periods ended December 31, 2015 and 2014; and ii) the amounts of cost of goods sold, operating expenses, selling expenses, administrative expenses and research and development expenses – net, if depreciation and amortization were allocated within those cost categories for the periods as noted above.

Depreciation by function	**Three-month periods ended December 31,**		**Six-month periods ended December 31,**	
	2015	2014	**2015**	2014
	$	$	**$**	$
Cost of goods sold	**114,076**	49,079	**212,418**	97,035
Operating expenses	**618**	706	**1,190**	1,485
Selling expenses	**9,471**	8,039	**18,391**	16,427
Administrative expenses	**20,478**	19,403	**39,987**	38,797
	144,643	77,227	**271,986**	153,744

Amortization by function	**Three-month periods ended December 31,**		**Six-month periods ended December 31,**	
	2015	2014	**2015**	2014
	$	$	**$**	$
Cost of goods sold	**119,683**	101,832	**236,982**	199,504
Selling expenses	**102,815**	94,038	**203,712**	189,402
Administrative expenses	**13,928**	13,406	**27,411**	26,414
	236,426	209,276	**468,105**	415,320

Cost per function including depreciation and amortization of intangible assets	**Three-month periods ended December 31,**		**Six-month periods ended December 31,**	
	2015	2014	**2015**	2014
	$	$	**$**	$
Cost of goods sold	**9,272,747**	10,668,439	**18,543,230**	19,000,247
Operating expenses	**319,504**	233,523	**654,056**	434,788
Selling expenses	**1,723,670**	1,171,431	**3,191,220**	2,181,472
Administrative expenses	**1,222,575**	1,158,842	**2,299,118**	2,179,040
Research and development expenses – net	**35,610**	49,502	**120,174**	89,424
	12,574,106	13,281,737	**24,807,798**	23,884,971

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

c) Research and development expenses – net

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Gross research and development expenses	**35,610**	49,502	**120,174**	89,424
Research and development tax credits and grants	**-**	-	**-**	-
	35,610	49,502	**120,174**	89,424

d) Other (gains) losses – net

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Realized exchange (gain) loss	**(6,479)**	34,829	**(61,789)**	36,947
Unrealized exchange loss	**203,682**	65,700	**257,087**	156,654
Other revenues (a)	**(4,157)**	(11,726)	**(381,835)**	(13,746)
	193,046	88,803	**(186,537)**	179,855

(a) Other revenues
An amount of $375,977 has been recorded in the first quarter of fiscal year 2016 following the indemnification by Piedmont's sellers due to a breach of certain of their representations and warranties contained in the Share Purchase Agreement dated December 5, 2013.

12. Net earnings per share

The following table sets out the weighted average basic and diluted number of outstanding shares used to compute the basic and diluted earnings per share:

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
Net earnings	**$174,221**	$117,524	**$226,550**	$400,111
Basic and diluted weighted average number of share outstanding	**20,926,551**	20,926,551	**20,926,551**	20,926,551
Basic and diluted net earnings per share	**$0.008**	$0.006	**$0.011**	$0.019
Items excluded from the calculation of diluted net earnings per share because the exercise price was greater than the average market price of the common shares or due to their anti-dilutive effect				
Stock options			**284,000**	331,500

For the three-month and six-month periods ended December 31, 2015 and 2014, the diluted net earnings per share was the same as the basic net earnings per share, since the effect of the assumed exercise of stock options and warrants to purchase common share is anti-dilutive. Accordingly, the diluted net earnings per share for these periods were calculated using the basic weighted average number of shares outstanding.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

13. Cash Flows

a) The change in non-cash working capital items is as follows:

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Accounts receivable	**(469,687)**	(378,110)	**(384,058)**	(1,979,255)
Inventories	**(851,471)**	(408,759)	**(1,431,603)**	125,430
Costs incurred in excess of billings	**(1,049,452)**	(1,034,625)	**(3,128,908)**	(1,553,953)
Prepaid expenses	**122,360**	55,865	**249,718**	9,160
Accounts payable and accrued liabilities	**1,710,193**	1,776,529	**3,418,523**	2,636,384
Provisions	**5,757**	(13,273)	**8,757**	(10,273)
Billings in excess of costs incurred	**(249,959)**	(1,155,981)	**(131,403)**	(770,173)
	(782,259)	(1,158,354)	**(1,398,974)**	(1,542,680)

b) Cash and cash equivalents consist of the following:

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Beginning of period				
Cash and cash equivalents	**1,964,605**	569,910	**1,335,887**	497,752
Bank overdraft	**(426,657)**	(557,543)	**(2,052)**	(113,383)
	1,537,948	12,367	**1,333,835**	384,369

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
End of period				
Cash and cash equivalents	**1,780,287**	198,633	**1,780,287**	198,633
Bank overdraft	**(167,011)**	(101,630)	**(167,011)**	(101,630)
	1,613,276	97,003	**1,613,276**	97,003

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

14. Segment Information

Products from which reportable segments derive their revenues

The Corporation operates under a single reportable segment consisting of delivering drinking water and process water production and wastewater treatment systems, including related services.

The following is an analysis of the Corporation's revenues for the period for the continuing operations.

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Revenues from sales of consumables	**7,247,557**	4,972,782	**12,325,794**	8,909,910
Manufacturing contracts revenues	**5,918,033**	8,716,278	**13,099,124**	15,998,281
	13,165,590	13,689,060	**25,424,918**	24,908,191

Geographical information

	Three-month periods ended December 31,		Six-month periods ended December 31,	
Revenue from external customers	**2015**	2014	**2015**	2014
	$	$	**$**	$
Revenue according to geographic location				
Canada	**2,634,787**	5,436,282	**5,106,870**	9,327,568
United States	**8,221,172**	7,100,967	**16,468,664**	12,646,062
China	**282,158**	339,088	**670,589**	1,149,632
Egypt	**333,860**	75,733	**533,599**	75,733
United Arab Emirates	**719,277**	3,127	**746,204**	26,301
Korea	**260,274**	76,124	**291,108**	117,979
Malaysia	**335,534**	-	**293,126**	2,309
Other	**378,528**	657,739	**1,314,758**	1,562,607
	13,165,590	13,689,060	**25,424,918**	24,908,191

Revenues are attributed to the various countries according to the customer's country of residence.

Information about major customers

The Company derived more than ten percent (10%) of its revenues from one single external customer during the three-month period ended December 31, 2015 (none for the three-month period ended December 31, 2014).

	As at December 31, 2015	As at June 30, 2015
	$	$
Non-current assets other than financial instruments and deferred tax assets according to geographic location		
Canada	**5,742,551**	3,097,671
United States	**13,535,376**	12,209,857
	19,277,927	15,307,528

15. Related parties disclosure

Compensation of key management personnel

The remuneration of members of key management personnel during the period was as follows:

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2015	2014	**2015**	2014
	$	$	**$**	$
Short-term benefits	**413,493**	312,928	**710,650**	579,856
Post-employment benefits	**9,743**	4,948	**18,439**	8,646
Share-based payments	**-**	-	**-**	2,155
	423,236	317,876	**729,089**	590,657

The remuneration of key executives is determined by the remuneration committee having regards to the performance of individuals and market trends.

GENERAL INFORMATION

Board of Directors

Philippe Gervais, Chairman of the Board[1]
Frédéric Dugré, President, Chief Executive Officer and Director[3]
Pierre Côté, Director[3]
Élaine C. Phénix, Director[1] [2]
Jean-Réal Poirier, Director[2] [3]
Richard Hoel, Director[1]
Lisa Henthorne, Director[2] [3]
Laurence E. Gamst, Director[1]
Peter K. Dorrins, Director[2]

Key Management

Frédéric Dugré, President and Chief Executive Officer
Marc Blanchet, Chief Financial Officer and Secretary
Guillaume Clairet, Chief Operating Officer[3]
Josée Riverin, Vice President, Finance

[1] Audit Committee
[2] Governance, Remuneration and Risks Committee
[3] Technology and Projects Committee

Legal Counsel
McCarthy Tétrault S.E.N.C.R.L.

Independent Auditors
Deloitte LLP

Transfer Agent
CST Trust Company

OFFICES AND PLANTS

Head Office
330, rue St-Vallier Est, Suite 340
Quebec City, Quebec, G1K 9C5
Phone: 418.688.0170
Fax: 418.688.9259

investor@h2oinnovation.com
www.h2oinnovation.com

Plants (North America)
201 1st Avenue
Ham-Nord, Quebec, G0P 1A0

1048 La Mirada Court
Vista, California 92081

8900, 109th Ave N, Suite 1000
Champlin, Minnesota 553160

Sales and Engineering Offices
1046 18th Ave SE
Calgary, Alberta T2G 1L6

5500, North Service Road, Suite 207
Burlington, Ontario L7L 6W6