

# **Changfeng Energy Inc.**

## **Management's Discussion and Analysis For The Three Months Ended March 31, 2014**

Dated May 14, 2014

## **Advisory**

The Management's Discussion and Analysis ("MD&A") provides an analysis to enable readers to assess material changes in financial condition and results of operations of Changfeng Energy Inc. ("Changfeng" or the "Company") for the three months ended March 31, 2014. This information should be read in conjunction with the Company's unaudited condensed consolidated interim financial statements and related notes for the quarter ended March 31, 2014 and the audited consolidated financial statements and related notes and the MD&A for the year ended December 31, 2013. "Changfeng" includes Changfeng Energy Inc. and its subsidiaries, unless otherwise indicated. Additional information related to Changfeng is available on SEDAR at [www.sedar.com](http://www.sedar.com) or on its website at [www.changfengenergy.com](http://www.changfengenergy.com).

The preparation of financial statements in conformity with International Financial Reporting Standards ("IFRS") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and expenses during the reporting period. Changfeng bases its estimates on historical experience, current trends and various other assumptions that are believed to be reasonable under the circumstances. Actual results could differ from those estimates.

This MD&A contains certain non-IFRS financial measures to assist users in assessing its performance. Non-IFRS financial measures do not have any standard meaning prescribed by IFRS and may not be comparable to similar measures presented by other issuers. These measures are identified and described under the section "Non-IFRS Financial Measures".

Unless otherwise noted, the Company's contractual obligations, commitments, and business risks and uncertainties, as described in its MD&A for the year ended December 31, 2013, are substantially unchanged.

Amounts are stated in Canadian dollars unless otherwise indicated.

## **Caution Regarding Forward-Looking Information**

Certain statements in this MD&A may constitute "forward looking" statements which involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company and its subsidiaries, or the industry in which they operate, to be materially different from any future results, performance or achievements expressed or implied by such forward looking statements. When used in this report, the words "estimate", "believe", "anticipate", "intend", "expect", "plan", "may", "should", "will", the negative thereof or other variations thereon or comparable terminology are intended to identify forward looking statements. Such forward looking statements reflect the current expectations of the management of the Company with respect to future events based on currently available information and are subject to risks and uncertainties that could cause actual results, performance or achievements to differ materially from those expressed or implied by those forward looking statements, such as significant changes in market conditions, the inability of the Company to realize sales and the inability of the Company to attract sufficient financing and the risk factors summarized below under the heading "Risk Factors". New risk factors may arise from time to time and it is not possible for management of the Company to predict all of those risk factors or the extent to which any factor or combination of factors may cause actual results, performance or achievements of the Company to be materially different from those expressed or implied in such forward looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward looking statements as a prediction of actual results. Although the forward looking statements contained in this MD&A are based upon what management believes to be reasonable assumptions, the Company cannot assure investors that actual results will be consistent with these forward looking statements. The forward looking statements contained in this MD&A speak only as of the date hereof. The Company does not undertake or assume any obligation to release publicly any revisions to these forward looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events, except as required by law.

## **Overview**

Changfeng is a Canadian public company currently trading on the TSX Venture Exchange ("TSX-V") under the stock symbol "CFY". Changfeng is a natural gas distribution company (or natural gas utility) in the People's Republic of China ("the PRC or China") with operations throughout southern China.

Currently the Company has three projects in operation, two of them are city piped natural gas distribution projects, and one compressed natural gas ("CNG") vehicle refueling station. Changfeng has a 30 year concession right to operate the gas distribution business in Sanya City, Hainan Province, and a 50 year operating right for its gas distribution business in the Xiangdong District, Pingxiang City, Jiangxi Province. Its customer base and exclusive operation provide recurring revenue and operating cash flows to the Company and let the Company, which allow it to pursue future expansion of its operations.

Since 2008 Changfeng has been actively exploring emerging market opportunities in mainland China which resulted from the construction of PetroChina's Second West-East Pipeline ("WEP II"). Today, Changfeng has grown through the responsible development and reliable operation of natural gas distribution pipelines and associated facilities in China. Highlights include:

❖ **In Sanya City, Hainan Province, China**

- 30-year exclusive concession rights (2007-2037) in Sanya City with wholly-owned gas distribution pipeline networks and associated facilities;
- Secured gas supply through its annual gas quota of 24 million cubic meters (m<sup>3</sup>) (848 million cubic feet (ft<sup>3</sup>)) until 2015 at a favorable price;
- Serving more than 120,696 residential and 729 commercial/industrial customers (primarily hotels and restaurants);
- Serving 7 hotels in Haitang Bay area, Sanya City.

❖ **In Xiangdong District, Pingxiang City, Jiangxi Province, China (Xiangdong Project)**

- 50-year exclusive operation rights (2010-2060) in the administrative region of Xiangdong District, including the Pingxiang Industrial Ceramic Production Park (the "Park");
- Secured gas supply through approval of a two-year gas quota: 50 million m<sup>3</sup> (1,765 million ft<sup>3</sup>) each for 2014 and 2015;
- Commenced the sale of natural gas to five ceramics manufacturers in the Park;
- Completed the installation of the main and service pipeline connecting to a gated community.

❖ **In Changsha City, Hunan Province, China**

- Continuing to grow its customer base.

The Company's primary goal is to become one of the predominant natural gas service providers in Southern China. In pursuit of this goal, Changfeng continually strives to advance effective execution of its growth strategy by exploring strategic business development opportunities in mainland China along WEP II. The Company believes that its ongoing projects will add value, generate revenues and leverage its strength to create long-term sustainable value for its shareholders and clients.

## Selected Quarterly Financial Information

The following table provides selected financial information for the three months ended March 31, 2014 and 2013:

| <i>In thousands of Canadian dollars<br/>except percentages and per share amounts</i> | Three month ended March 31, |              |         |       |
|--|-----------------------------|--------------|---------|-------|
|  | 2014                        | 2013         | Change  | %     |
| Revenue  | 13,381                      | 9,623        | 3,758   | 39%   |
| <b>Gross margin</b>  | <b>7,790</b>                | <b>5,572</b> | 2,218   | 40%   |
| <b>% of revenue</b>  | <b>58.2%</b>                | <b>57.9%</b> | 0.3%    |       |
| General and administrative   | 2,738                       | 2,161        | 577     | 27%   |
| % of revenue   | 20.5%                       | 22.5%        | -2.0%   |       |
| Travel and business development  | 1,077                       | 962          | 115     | 12%   |
| % of revenue   | 8.0%                        | 10.0%        | -1.9%   |       |
| Stock based compensation   | 87                          | -            | 87      |       |
| % of revenue   | 0.7%                        | 0.0%         | 0.7%    |       |
| <b>Total expenses</b>  | <b>3,902</b>                | <b>3,123</b> | 779     | 25%   |
| <b>% of revenue</b>  | <b>29.2%</b>                | <b>32.5%</b> | -3.3%   |       |
| <b>Income before interest, equity loss and income taxes</b>                          | <b>3,887</b>                | <b>2,449</b> | 1,438   | 59%   |
| <b>% of revenue</b>  | <b>29.1%</b>                | <b>25.4%</b> | 3.6%    |       |
| Interest expense   | 490                         | 442          | 48      | 11%   |
| % of revenue   | 3.7%                        | 4.6%         | -0.9%   |       |
| Interest income  | (9)                         | (9)          | 0.0     | 0%    |
| % of revenue   | -0.1%                       | -0.1%        | 0.0%    |       |
| Share of loss of investment in associate   | 7.6                         | 0.3          | 7       | 2333% |
| <b>Income before income taxes</b>  | <b>3,399</b>                | <b>2,016</b> | 1,383   | 69%   |
| <b>% of revenue</b>  | <b>25.4%</b>                | <b>20.9%</b> | 4.5%    |       |
| Income tax   | 1,469                       | 744          | 725     | 97%   |
| % of revenue   | 11.0%                       | 7.7%         | 3.2%    |       |
| <b>Net income</b>  | <b>1,930</b>                | <b>1,273</b> | 657     | 52%   |
| % of revenue   | 14.4%                       | 13.2%        | 1.2%    |       |
| <b>EBITDA (1)</b>  | <b>5,019</b>                | <b>3,001</b> | 2,018   | 67%   |
| <b>% of revenue</b>  | <b>37.5%</b>                | <b>31.2%</b> | 6.3%    |       |
| Non-controlling interest   | (22)                        | (19)         | (3)     | 16%   |
| Basic EPS  | 0.030                       | 0.020        | 0.010   | 50%   |
| Diluted EPS  | 0.030                       | 0.020        | 0.010   | 50%   |
| Weighted average number of<br>common shares outstanding - Basic                      | 64,172                      | 66,025       | (1,853) | -3%   |
| Weighted average number of<br>common shares outstanding - Diluted                    | 65,146                      | 66,686       | (1,540) | -2%   |

Note: (1) EBITDA is identified and defined under the section "Non-IFRS Financial Measures".

## Results of Operations

### *Revenue*

Revenue for the first quarter of 2014 was \$ 13.4 million, representing an increase of \$3.8 million, or 39%, from \$9.6 million for the same period of 2013. This increase is mainly attributable to more revenue recognized from the connection fees and continued gas volume growth (3%).

The table below illustrates the customers connected during the three-month periods ended March 31, 2014 and 2013, and presents the volume of natural gas sold in the Sanya Region, as well as the volume of gas sold from the CNG refueling retail station in Changsha City for these periods.

For the three months ended March 31, 2014

|   | Three months ended March 31, |                       | Change                |
|---|------------------------------|-----------------------|-----------------------|
|   | 2014                         | 2013                  |                       |
| <b>1. Gas Distribution Utility Segment</b>  |                              |                       |                       |
| <b>1.1. Sanya Operation</b>   |                              |                       |                       |
| <i>Residential customers</i>  |                              |                       |                       |
| Customers connected during the period   | 2,031                        | 4,819                 | -2,788                |
| Total customers at the end of the period  | 120,696                      | 103,988               | 16,708                |
| Gas volume sold (m <sup>3</sup> ) during the period   | 2,860,000                    | 2,975,413             | -115,413              |
| <i>Commercial customers</i>   |                              |                       |                       |
| Customers connected during the period   | 7                            | 53                    | -46                   |
| Total customers at the end of period  | 729                          | 699                   | 30                    |
| Gas volume sold (m <sup>3</sup> ) during the period   | 8,160,000                    | 7,942,990             | 217,010               |
| <b>Sub-total gas volume sold (m<sup>3</sup>) during the period</b>                            | <b>11,020,000</b>            | <b>10,918,403</b>     | <b>101,597</b>        |
| <b>Sub-total sales revenue in RMB (connection fee included)</b>                               | <b>RMB 61,663,599</b>        | <b>RMB 49,024,357</b> | <b>RMB 12,639,242</b> |
| <b>Sub-total sales revenue in C\$ (connection fee included)</b>                               | <b>C\$ 11,148,878</b>        | <b>C\$ 7,946,848</b>  | <b>C\$ 3,202,030</b>  |
| <b>1.2. Xiangdong Operation</b>   |                              |                       |                       |
| <i>Residential customers</i>  |                              |                       |                       |
| Customers connected during the period   | 69                           | -                     | 69                    |
| Total customers at the end of the period  | 334                          | -                     | 334                   |
| Gas volume sold (m <sup>3</sup> ) during the period   | 9,146                        | -                     | 9,146                 |
| <i>Industrial customers</i>   |                              |                       |                       |
| Industrial customers connected during the period  | -                            | 2                     | -2                    |
| Industrial customers at the end of the period   | 5                            | 2                     | 3                     |
| Gas volume sold (m <sup>3</sup> ) during the period   | 250,207                      | 31,000                | 219,207               |
| <b>Sub-total gas volume sold (m<sup>3</sup>) during the period</b>                            | <b>259,354</b>               | <b>31,000</b>         | <b>259,354</b>        |
| <b>Sub-total sales revenue in RMB (connection fee included)</b>                               | <b>RMB 1,132,454</b>         | <b>RMB -</b>          | <b>RMB 1,132,454</b>  |
| <b>Sub-total sales revenue in C\$ (connection fee included)</b>                               | <b>C\$ 204,749</b>           | <b>C\$ -</b>          | <b>C\$ 204,749</b>    |
| <b>Sub-total gas volume sold (m<sup>3</sup>) during the period (Gas distribution utility)</b> | <b>11,279,354</b>            | <b>10,949,403</b>     | <b>329,951</b>        |
| <b>Sub-total gas sales revenue in RMB (Gas distribution utility)</b>                          | <b>RMB 62,796,052</b>        | <b>RMB 49,024,357</b> | <b>RMB 13,771,695</b> |
| <b>Sub-total gas sales revenue in C\$ (Gas distribution utility)</b>                          | <b>C\$ 11,353,628</b>        | <b>C\$ 7,946,848</b>  | <b>C\$ 3,406,779</b>  |
| <b>2. CNG Refueling Station Segment</b>   |                              |                       |                       |
| <b>2.1. Changsha's CNG refueling retail station</b>   |                              |                       |                       |
| <b>Sub-total CNG volume sold (m<sup>3</sup>) during the period</b>                            | <b>3,061,101</b>             | <b>2,786,281</b>      | <b>274,820</b>        |
| <b>Sub-total CNG sales revenue in RMB</b>   | <b>RMB 11,210,799</b>        | <b>RMB 10,339,260</b> | <b>RMB 871,540</b>    |
| <b>Sub-total CNG sales revenue in C\$</b>   | <b>C\$ 2,026,931</b>         | <b>C\$ 1,675,994</b>  | <b>C\$ 350,937</b>    |
| <b>Total gas volume sold (m<sup>3</sup>) during the period</b>                                | <b>14,340,454</b>            | <b>13,735,684</b>     | <b>604,770</b>        |
| <b>Total sales revenue in RMB (connection fee included)</b>                                   | <b>RMB 74,006,851</b>        | <b>RMB 59,363,617</b> | <b>RMB 14,643,234</b> |
| <b>Total sales revenue in C\$ (connection fee included)</b>                                   | <b>C\$ 13,380,559</b>        | <b>C\$ 9,622,842</b>  | <b>C\$ 3,757,717</b>  |

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#### *Gas distribution utility*

Sales from the gas distribution utility for the three months ended March 31, 2014 were \$11.4 million, an increase of \$3.4 million, or 43%, from \$8.0 million for same period of 2013. This increase was attributable to the following:

- the 11.5% appreciation of exchange rate between the Chinese RMB and the Canadian dollar.
- an increase in connection fees in the Sanya operation;
- increased gas volume sold of 11.0 million m<sup>3</sup> in the Sanya operation in the first three months of 2014 compared to 10.9 million m<sup>3</sup> sold in Sanya operation in the same period of 2013; and
- increased gas volume sold of 0.3 million m<sup>3</sup> in the Xiangdong operation in the first three months of 2014 compared to 0.0 million m<sup>3</sup> sold in the same period of 2013.

The Company's non-residential customers include both commercial and industrial customers, mainly comprised of the hotels, resorts and restaurants in Sanya City. Currently, approximately 74% of the total annual volume of gas in Sanya City is sold to these non-residential customers. Sanya municipal government's approval of the sales price increase related to the implementation of the long-term Budget Process (the "Budget Process"), which was implemented as part of the solution to address the ongoing gas deficit issue in the Sanya region. The Budget Process is intended to provide (a) an annual subsidy for the loss, if any, on the gas sales to its residential customers; and (b) periodic sales price adjustments for its commercial customers enabling the sales prices to reflect the interaction between supply and demand; however, there is no guarantee that the Budget Process will be successfully implemented by the government in the future.

The Company commenced the sale of natural gas to four industrial customers in the Xiangdong region and completed the installation of the main and service pipeline connecting to a gated community and started to sell natural gas to residential customers in the gated community in the downtown area of Xiangdong region. The Company is expecting to eventually connect 2,000 new residential customers and to serve another 8,000 residential customers by upgrading their coke gas fueled facilities to natural gas fueled facilities in the downtown of Xiangdong region.

#### *CNG vehicle refueling station*

Total revenue from the CNG refueling retail station for the three months ended March 31, 2014 was \$2.0 million, an increase of \$0.3 million, or 18%, from \$1.7 million for same period of 2013.

The increase was attributable to the combined effect of the increased gas volume sold and the appreciation of exchange rate between the Chinese RMB and the Canadian dollar. (3.0 million m<sup>3</sup> in the three months ended March 31, 2014 compared to 2.8 million m<sup>3</sup> sold in the same period of 2013). The Company has been upgrading its station's refueling capacity to meet the increasing demand that is primarily driven by both rising gasoline prices and continued government support for clean energy vehicles. It is expected that more existing gasoline-fueled buses in the city will be converted into dual-fuel vehicles (gasoline/CNG).

#### *Foreign exchange rates*

Changfeng reports its financial results in Canadian dollars but earns all of its revenues and incurs most of its expenses in Chinese Renminbi ("RMB"). Accordingly, any fluctuation in the exchange rate between these two currencies will affect the reported financial information. The impact of the changes in foreign exchange rates has been recognized as other comprehensive income, and not as net income.

| <b>One Chinese RMB to Canadian dollars</b> | <b>Q1'2014</b> | <b>Q1'2013</b> | <b>% change</b> |
|--|----------------|----------------|-----------------|
| Spot rate at the end of the quarter        | 0.1778         | 0.1634         | 8.8%            |
| Average rate for the quarter               | 0.1808         | 0.1621         | 11.5%           |

#### *Gross margin*

Gross margin for the first quarter of 2014 increased \$2.2 million, or 40%, to \$7.8 million from \$5.6 million for the comparable period in 2013. The gross margin percentage of 58% for the first quarter of 2014 is approximately the same as for the first quarter of 2013.

For the three months ended March 31, 2014

As a percentage of revenue, the gross margin of the gas distribution utility improved 2% (66% for the first quarter of 2014 versus 64% for the same period of 2013) reflecting the reduced volume of gas purchased at market rate prices and higher-value commercial customers from the Haitang Bay district in the Sanya Region. The increase was also attributable to more connection fees. As a percentage of revenue, the gross margin of the CNG refueling station decreased 6% (18% for the first quarter of 2014 versus 24% for the same period of 2013) primarily due to increases in purchase price and operating costs that increased at a higher rate than gas volume sold.

### *Operating expenses*

**General and administrative expenses** for the first quarter of 2014 were \$2.7 million, an increase of \$0.6 million, or 27%, from \$2.2 million in the same period of 2013. The increase was attributable to higher employee salaries and benefits as a result of a higher inflation rate in China, additional employees, higher conference and professional fees and higher exchange rate between the Chinese RMB and the Canadian dollar. General and administrative expenses as a percentage of sales for the first quarter of 2014 decreased to 20% from 22% in the first quarter of 2013.

**Travel and business development expenses** for the first quarter of 2014 were \$1.1 million, an increase of \$0.1 million, or 12%, from \$1.0 million in the first quarter of 2013. Travel and business development expenses as a percentage of sales for the first quarter of 2014 decreased to 8% from 10% in the first quarter of 2013. These expenses normally fluctuate with travel and business development activities in mainland China as the Company seeks to develop new projects in close proximity to the new national pipelines.

**Interest on long term debt** for the first quarter of 2014 and the same period of 2013 was \$0.49 million and \$0.44 million, respectively, an increase of \$0.05 million. The increase is due to the additional long-term loans obtained by the Company in 2013.

### *EBITDA*

EBITDA (non-IFRS measure as identified and defined under section "Non-IFRS Measures") for the first quarter of 2014 was \$5.0 million, an increase of \$2.0 million, or 67%, from \$3.0 million for the same period of 2013. The increase was driven primarily by higher sales. EBITDA as a percentage of revenue for the first quarter of 2014 was 38%, compared to 31% in the first quarter of 2013, representing an increase of 7% due to the sales increases but was partially offset by higher operating expenses, as discussed above.

### *Net income*

Net income for the first quarter of 2014 was \$1.9 million, or \$0.030 per share (basic and diluted) compared to \$1.3 million or \$0.020 per share (basic and diluted) for the same period in 2013, primarily due to the reasons discussed above.

## **Selected Quarterly Results**

The following sets out the Company's consolidated quarterly results for the most -recently completed quarters:

| Quarterly data (\$000's)<br>except per share amounts      | 2014   | 2013   |        |        |        | 2012   |        |        |
|---|--------|--------|--------|--------|--------|--------|--------|--------|
|   | Q1     | Q4     | Q3     | Q2     | Q1     | Q4     | Q3     | Q2     |
| Foreign exchange rate one Chinese RMB to Canadian dollars | 0.1808 | 0.1675 | 0.1660 | 0.1642 | 0.1621 | 0.1584 | 0.1564 | 0.1595 |
| Revenue   | 13,381 | 12,996 | 10,240 | 9,190  | 9,623  | 10,857 | 7,929  | 7,122  |
| Gross profit  | 7,790  | 5,230  | 4,867  | 4,329  | 5,572  | 5,112  | 3,218  | 3,472  |
| Interest  | 490    | 316    | 443    | 437    | 442    | 313    | 367    | 387    |
| Net income (loss)   | 1,930  | 345    | 571    | 625    | 1,273  | 771    | 55     | 826    |
| Net income (loss) per share                               |        |        |        |        |        |        |        |        |
| - basic   | 0.030  | 0.005  | 0.010  | 0.010  | 0.020  | 0.011  | 0.001  | 0.013  |
| - diluted   | 0.030  | 0.005  | 0.010  | 0.010  | 0.020  | 0.011  | 0.001  | 0.013  |

## **Financial Condition and Liquidity**

| Key Financial Data and Comparative Figures  |           |           |
|---|-----------|-----------|
| (\$000's)                                   | 31-Mar-14 | 31-Dec-13 |
| Cash  | 15,206    | 15,151    |
| Working capital (deficit)                   | (8,717)   | (9,465)   |
| Adjusted working capital (deficit) (note 1) | 8,469     | 8,375     |
| Plant and equipment                         | 59,174    | 57,311    |
| Total assets                                | 85,055    | 83,637    |
| Long term liabilities                       | 32,874    | 32,495    |
| Shareholders' equity                        | 22,484    | 20,540    |

Note 1: This financial measure is identified and defined under the section "Non-IFRS Financial Measures".

Cash increased by \$0.05 million to \$15.20 million at March 31, 2014 from \$15.15 million at December 31, 2013, primarily resulting from cash provided during the quarter by operating activities of \$2.1 million and effects of foreign exchange on cash balances of \$0.2 million, offset by \$0.1 million repayment of long-term debt, \$0.3 million for share buyback and cash used for capital expenditures of \$1.9 million during the quarter.

### **Adjusted Working Capital**

The adjusted working capital (see "Non-IFRS Financial Measures") was \$8.5 million at March 31, 2014. Adjusted working capital excludes \$13.8 million of deferred revenue in connection with gas connection fees and \$3.4 million of line of credit.

### **Liquidity and Capital Resources**

#### *Overview*

The Company's principal sources of short-term funding are its existing cash balances, operating cash flows and borrowing under its line of credit. Its principal source of long-term funding is its bank term loans into which it entered in January 2010, December 2012 and January 2013, respectively.

The Company's principal sources of liquidity are cash provided by operations, including advance payments from residential and commercial and industrial customers related to construction contracts for gas connection, and access to credit facilities and capital resources. The Company's primary short-term cash requirement is to fund working capital, and repay the remainder of its outstanding withdrawal on its line of credit.

The Company's medium and long-term cash goals are to fund construction of its pipeline networks and gas distribution facilities, to acquire capital and intangible assets for its growth initiatives in mainland China and to repay its long-term loans from the BOC and BOC, Pingxiang.

In the short term, management does not expect to face any liquidity problems considering its ability to generate sustainable cash flow from operations in the short and long term. The Company has not experienced any difficulties in collecting its outstanding receivables from its customers and expects no such difficulties in the foreseeable future.

#### *Long-term bank loans*

On December 21, 2012, the Company entered into a term loan with the Bank of China, Pingxiang Branch ("BOC, Pingxiang") for \$3.6 million (RMB 20.0 million), maturing six years from the date of the first withdrawal, and bearing interest at 120% of the prime rate of the People's Bank of China. This term loan is secured by the property and equipment of Pingxiang CF and guaranteed by CF China. The proceeds from this term loan were used to fund the construction of pipelines and related property and equipment in the Xiangdong district, Pingxiang City, Jiangxi province. As of the date of this MD&A, the Company withdrew \$3.6 million (RMB 20.0 million) and repaid \$0.1 million (RMB 0.8 million).

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On January, 15, 2013 the Company entered an agreement with BOC, Sanya Branch to secure a bank loan facility in the amount of \$8.9 million (RMB 50.0 million) (the "Term Loan"). The Term Loan agreement requires that the proceeds be used to fund continued construction of pipeline and associated facilities for the Haitang Bay project in Sanya City, Hainan Province, China. It has a ten-year term from the date of the first initial withdrawal, and bears interest of 110% of the prime rate set by the People's Bank of China. Upon execution of the agreement, the Company made a withdrawal of \$7.1 million (RMB 40.0 million).

The Company believes that its ability to obtain funding from these long-term debt bank loans and solid operating cash flows will continue to provide the cash flows necessary to satisfy our working capital and capital expenditure requirements, as well as meet its debt repayments and other financial commitments.

#### *Cash flow from operations*

Net cash provided by operations was \$2.1 million for the first quarter of 2014 compared to \$1.7 million for the same period of 2013.

#### *Cash Flow from Financing Activities*

Cash used in financing activities in the first quarter of 2014 included a \$0.1 million principle payment of long-term debt and \$0.3 million paid for the share buyback.

#### *Investing Activities*

Capital expenditures in property and equipment totaled \$1.9 million in the first quarter of 2014 compared to \$2.2 million in the same period of 2013. The expenditures were mainly related to the purchase of equipment for the Xiangdong project and the on-going construction of pipeline networks to connect new customers in the Sanya Region.

Changfeng will finance the majority of the upcoming construction of projects under development in mainland China through its long-term bank loans with BOC Sanya and BOC Pingxiang, as well as operating cash flow from its existing operations.

## **Contractual Obligations and Commitments**

As of March 31, 2014, there have been no significant changes to contractual obligations and commitments since December 31, 2013.

## **Off-Balance Sheet Arrangements**

As a policy, Changfeng does not enter into off-balance sheet arrangements with special purpose entities, nor does it have any unconsolidated affiliates that have not been accounted for in these financial statements.

## **Share Capital**

As at the date of this MD&A, the Company has 63,109,200 common shares outstanding, 6,300,000 stock options outstanding and exercisable at a weighted average exercise price of \$0.34 per share. The Company has no warrants outstanding.

During the first quarter of 2014, the Company purchased for cancellation 743,000 of its common shares under its normal-course issuer bid (the "Bid") for cash of \$292,279. These shares were cancelled automatically after the Company purchased them. Subsequent to March 31, 2014, the Company purchased 787,000 shares pursuant to the Bid for cash of \$302,378.

For the three months ended March 31, 2014

### **Seasonality of Operations**

Seasonality can impact the Company's pipeline natural gas sales. The Company's current operations are mainly located in the Sanya Region, a tourist area in the PRC's only tropical province that attracts more tourists in winter than the rest of the year. As a large portion of the Company's natural gas sales are made to hotels and restaurants, the Company's sales are affected by tourism.

Seasonality can also impact the Company's CNG retail station sales due to vehicles being in need of more gas during the warmer seasons for air conditioning.

### **Non-IFRS Financial Measures**

This MD&A contains certain financial measures that do not have any standardized meaning prescribed by IFRS. Therefore, these financial measures may not be comparable to similar measures presented by other issuers. Investors are cautioned that these measures should not be construed as alternatives to net income or to cash provided by operating, investing, and financing activities determined in accordance with IFRS, as indicators of its performance. Changfeng provides these measures to assist investors in determining its ability to generate income and cash provided by operating activities, and to provide additional information on how these cash resources are used. These measures are listed and defined below:

#### **EBITDA**

EBITDA is defined herein as income before income tax expense, interest expense, depreciation and amortization, share of loss of investment in associate, as well as non-cash stock-based compensation expense. EBITDA does not have any standardized meaning prescribed by IFRS and therefore may not conform to the definition used by other companies.

A reconciliation of net income to EBITDA for each of the periods presented in this MD&A follows:

| In thousands<br>(except for % figures)   | Three months ended March 31, |              |              |            |
|--|------------------------------|--------------|--------------|------------|
|  | 2014                         | 2013         | Change       | %          |
| Net Income                               | 1,930                        | 1,273        | 657          | 52%        |
| Add (less):                              |                              |              |              |            |
| Income tax                               | 1,469                        | 744          | 725          | 97%        |
| Interest income                          | (9)                          | (9)          | 0            | 0%         |
| Share of loss of investment in associate | 7.6                          | 0.3          | 7            | 2333%      |
| Stock-based compensation                 | 87                           | -            | 87           | 100%       |
| Amortization                             | 1,044                        | 551          | 493          | 89%        |
| Interest expense                         | 490                          | 442          | 48           | 11%        |
| <b>EBITDA</b>                            | <b>5,019</b>                 | <b>3,001</b> | <b>2,018</b> | <b>67%</b> |

#### **Adjusted working capital**

Adjusted working capital is calculated as current assets less adjusted current liabilities. Adjusted current liabilities is calculated as current liabilities, excluding deferred revenue in connection with gas connection fees, which are deferred when Changfeng receives payments from customers in advance of work having commenced and are recognized on the percentage of completion method, as well as the credit line. As is the practice with lines of credit in China, typically, they are renewed when due.

Changfeng believes that adjusted working capital is a useful supplemental measure as it provides an indication of its ability to settle its debt obligations as they come due.

The calculation of adjusted working capital is provided in the table below:

For the three months ended March 31, 2014

| <b>As at</b><br><b>In \$ thousands</b>    | <b>March 31,</b><br><b>2014</b> | <b>December 31,</b><br><b>2013</b> |
|---|---------------------------------|------------------------------------|
| Current assets                            | 20,981                          | 21,137                             |
| Less: Current liabilities                 | 29,698                          | 30,603                             |
| Working capital (deficit)                 | (8,717)                         | (9,466)                            |
| Add: Deferred revenue                     | 13,750                          | 14,489                             |
| Line of credit                            | 3,436                           | 3,352                              |
| <b>Adjusted working capital (deficit)</b> | <b>8,469</b>                    | <b>8,375</b>                       |

## **Financial Instruments**

The Company does not have complex financial instruments, and the various risks related to these financial instruments, including foreign currency risk, commodity price risk, interest rate risk, concentration of credit risk and liquidity risk have been disclosed in our audited Consolidated Financial Statements and MD&A for the year ended December 31, 2013 and the notes thereto that are available at [www.sedar.com](http://www.sedar.com).

## **Transactions With Related Parties**

- I. As at March 31, 2014, the Company had an outstanding loan of \$0.4 million (RMB 2 million) due from the minority shareholder of Hunan Changfeng CNPC Energy Co., Ltd. ("Hunan CF CNPC"), which used the funds to contribute the capital it owed to that subsidiary. The minority shareholder has waived its right to any future profit that it would otherwise be allocated until the loan is repaid. The Company will begin recording this shareholder's profit allocation prospectively at the time the loan has been repaid. On May 4, 2012, the Company entered into supplementary agreements with this minority shareholder. Pursuant to the supplementary agreements, the loan will be due on June 8, 2015, secured by this minority shareholder's 40% equity interest in Hunan CF CNPC and bearing interest at 120% five-year term loan rate prescribed by the People's Bank of China.
- II. Included in current due to related parties as at March 31, 2014, was a required capital contribution of \$0.5 million (RMB 3 million) (December 31, 2013 - \$0.5 million (RMB 3 million in long-term)) to be made to Shin-Ko Energy. Also, included in current due to related parties as at March 31, 2014, was \$0.2 million (RMB 1.2 million) (December 31, 2013 - \$0.2 million (RMB 1.3 million)) relating to a loan made to the Company by Shin-Ko Energy. The loan is interest-free and is not secured. It is payable on demand.
- III. In 2007, a significant shareholder, who is also an officer and director of the Company, advanced loans in the aggregate amount of \$7.1 million (RMB 40 million) (December 31, 2013 - \$7.0 million (RMB 40 million)) to the Company, through wholly owned corporations, in accordance with a Subordination and Forbearance Agreement dated April 27, 2007, Consignment Loan Agreements dated May 23, 2007 and June 26, 2007, and other ancillary documentation. These loans are unsecured, non-interest bearing, are subordinated to the claims of all other creditors, including unsecured creditors, of the Company, and are due on demand; however, the lender cannot demand the repayment of the loans at any time until April 27, 2015. These corporations and the Company have entered into Loan Renewal Agreements whereby the parties have agreed to enter into further loan renewal agreements upon the same terms and conditions as the Consignment Loan Agreements, in perpetuity.
- IV. As at March 31, 2014, the Company owed an officer and director of the Company \$0.6 million (December 31, 2013 - \$0.6 million) for unpaid salary.

## **Risk Factors**

The Company manages a number of risks to achieve an acceptable level of risk without appreciably hindering its ability to maximize returns. Management has procedures in place to identify and manage significant operational and financial risks. A discussion of the Company's risks is included in the Company's MD&A for the year ended December 31, 2013.

## **Significant Accounting Policies**

### **Accounting standards adopted during the quarter**

During the quarter, the Company adopted several new accounting standards and amendments; however, they impact neither the Company's annual consolidated financial statements nor its condensed consolidated interim financial statements, beyond certain additional disclosure requirements expected for the 2013 annual consolidated financial statements.

### **Future Accounting Changes**

Certain pronouncements were issued by the IASB or the IFRS Interpretations Committee that are not yet effective for the quarter ended March 31, 2014, and have not been applied in preparing the Company's condensed consolidated financial statements. A discussion of the future accounting changes is included in the Company's MD&A for the year ended December 31, 2013.

## **Outlook**

The outlook for 2014 continues to be positive. The Company expects to continue to add both residential and commercial and industrial customers to its existing pipeline networks in the Sanya Region and Xiangdong District, and the volume of gas sold during 2014 will continue to increase especially from its operations in the Sanya Region with the upcoming additional volume of gas supply to be obtained from the Gas & Electricity Exchange Program.

In 2014, Changfeng will continue to implement its long-term growth strategy through its proposed joint venture for the pipelined gas project in the Western Guangdong Area of the Guangdong province, China.