# Changfeng Energy Inc.

## Management's Discussion and Analysis
## For the year ended December 31, 2013

Dated April 24, 2014

# Advisory

This Management's Discussion and Analysis ("MD&A") provides an analysis to enable readers to understand the financial position and operations of Changfeng Energy Inc. ("Changfeng" or the "Company") as at and for the year ended December 31, 2013. This information should be read in conjunction with the accompanying audited Consolidated Financial Statements of the Company and the notes thereto 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 or on its website at www.changfengenergy.com.

The preparation of financial statements in conformity with International Financial Reporting Standards ("IFRS or GAAP") 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-GAAP financial measures to assist users in assessing its performance. Non-GAAP financial measures do not have any standard meaning prescribed by GAAP and may not be comparable to similar measures presented by other issuers. These measures are identified and described under the section "Non-GAAP Financial Measures".

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").

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 strong operating cash flows to 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 that 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 ($m^3$) (848 million cubic feet ($ft^3$)) until December 31,2015 at a favorable price;
  - Serving more than 118,665 residential and 722 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 m3 (1,765 million ft3) 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**
  - Upgraded CNG retail station's capacity to meet the increasing demand;
  - Benefited from the 15% approved sale price increase obtained in late 2012.

The Company's primary goal is to become one of the predominant natural gas service providers in Southern China by 2015. 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.

## Vision and Strategy

**Vision**

Changfeng is committed to contributing to a cleaner China and improving the quality of life by providing clean and safe energy to its customers.

Its vision is to become one of the predominant natural gas service providers in Southern China by the year 2015.

**History**

Changfeng was founded in 1995 as a privately-owned natural gas utility serving residential, commercial and industrial customers in Sanya City. In 2007, 30-year exclusive concession rights were granted to Changfeng by the local government to operate pipeline construction and gas distribution operations in the city.

Since 2003, Changfeng has been building an extensive pipeline network in the main district of Sanya City. In December 2010, Changfeng completed the extension of a 26.6 km of high-to-medium pressure pipeline linking Sanya City with the

Haitang Bay region together with 21.2 km of low-pressure pipeline, and commenced the supply of gas to this newly-developed district of Sanya City.

Since 2010, the Company completed the construction of its first CNG filling station and commenced operations. In 2012, the Company upgraded its CNG retail station's capacity to meet the increasing demand.

In 2013, the company commenced the sale of natural gas to five ceramics manufacturers in the Park and completed the installation of the main and service pipeline connecting to a gated community for its Xiangdong project.

**Growth Strategy**

Changfeng's corporate strategy is to maximize operating cash flow of its existing operations, and to pursue long-term growth opportunities that add long-term shareholder value while focusing on its core operations in the natural gas business in China. The following initiatives are central to Changfeng`s growth strategy:

- Maximize operating cash flow from its Pipeline Gas Distribution in Sanya through securing additional gas quotas with more competitive purchase pricing; and
- Focus on commercial-intensive, underdeveloped markets in medium and small cities in mainland China.

It is critical to successfully execute its growth strategies in order to achieve its vision. Below and throughout this MD&A, Changfeng will discuss the execution of its business strategy for 2014 and beyond.

***Maximize operating cash flow from its Pipeline Gas Distribution in Sanya through securing additional gas quotas with more competitive purchase pricing***

Firstly, its strategy is to continue to grow its business in the Sanya Region where Changfeng has strong secular growth trends in tourism and real estate development. However, ever since 2010, demand for natural gas in this region has greatly exceeded its annual 24 million $m^3$ quota gas ("Quota Gas") due to both urban expansion and rapid development of coastal tourism. Its Quota Gas in Sanya Region, which was originally established in 2006 and is set to expire at the end of 2015, at a relatively fixed purchase price, cannot fully meet the market demand. Changfeng anticipates that the gas shortage situation in Sanya Region will not be significantly mitigated until 2015 when CNOOC completes construction and commences operation of its LNG receiver terminal that is currently under construction in Hainan Island. As a result, in the short term until 2015, its strategy is to maximize the profits and operating cash flows from its Sanya's operation through the gas supply management, which aims to maintain the gross margin on the sales of the extra gas beyond the Quota Gas. This strategy will enable its existing operation in Sanya Region to provide continued solid free operating cash flows which in part, are funding its strategic business development and expansion endeavors that are currently underway in mainland China.

At the same time, Changfeng has been working closely with the municipal government to find solutions to mitigate the negative effects of the gas shortage and higher gas pricing for Other Gas. Some practical measures to address the problem include a sales price increase to commercial customers, a government subsidy, and additional temporary gas quota, have been implemented successfully and the Gas to Electricity Exchange Program which will provide a 5 million $m^3$ natural gas to the Company in 2014 and 2015.

***Focus on commercial-intensive, underdeveloped markets in medium and small cities along the WEP II in mainland China***

Changfeng will continue to explore and develop gas distribution business opportunities in the emerging markets in mainland China, especially along WEP II. As a major national project of the China's 11th Five-Year Plan, construction of WEP II started on 22 February 2008. The trunk pipeline of WEP II has been completed and commenced the supply of gas in June 2011, and is to bring 30 billion $m^3$ annually of new gas to China over the next 30 years. As a result, there is a significant need for natural gas distribution utilities to provide a distribution solution to take new gas from national pipelines and deliver it to end users.

The Company's focus continues to be on commercial-intensive, underdeveloped markets in medium and small cities in these regions. Changfeng believes that this focused growth strategy enables us to grow its business rapidly, but at the same time, to minimize its capital expenditure requirements by limiting the potential size and length of gas pipelines through directly connecting the vast natural gas users such as industrial companies and gas-fired plants to the existing and/or planned national or provincial gas pipelines.

Currently, two of the projects are in commercial operation, which are the CNG refilling station in Changsha City, and Piped Gas Distribution in Xiangdong distrit, Pingxiang City. The Company is also pursuing a potential gas distribution opportunity in the Western Guangdong Area of Guangdong Province, China.

## 2013 Accomplishments

- On November 21, 2013, the Company renewed its normal-course issuer bid (the "Bid") and received approval from the TSX-V. Pursuant to the Bid, the Company proposes to purchase through the facilities of the Exchange, from time to time over the next 12 months, if considered advisable, up to an aggregate of 3,000,000 common shares. The Bid commenced on November 26, 2013 and will conclude on the earlier of the date on which purchases under the bid have been completed and November 26, 2014.
- On November 19, 2013, the Company has drawn down the full amount of a US$1,500,000 term loan (the Term Loan) from the Bank of China (Canada) pursuant to a Credit Facility Letter Agreement effective October 30, 2013. The Term Loan is secured by a Standby Letter of Credit provided by the Company and issued by the Bank of China Hainan Branch for the amount of RMB10,000,000. The Term Loan has a one-year term from the date of the withdrawal and bears annual interest of 6-month LIBOR Rate plus 250bps.
- In the third quarter of 2013, the Company has identified two gas fueled power plants as its phase I targeted customers ("Phase I"). The Company intends to establish a joint venture with PetroChina Kunlun Gas Co., Ltd ("CNPC Kunlun Gas"), a wholly owned subsidiary of PetroChina, to build high pressure transmission pipelines and associated facilities (the "Pipelines") to link the existing and/or planned provincial trunk lines to certain gas fueled power plants located in Guangdong Province, China. The Company filed a feasibility study on the first potential gas fueled power plant in Phase I with CNPC Kunlun Gas and is now reviewing CNPC Kunlun Gas' feedback and preparing a revised feasibility study which will be submitted shortly. The Company has also submitted an initial project proposal on the second potential gas fueled power plant in Phase I to CNPC Kunlun Gas for its review. If the initial project proposal is accepted by CNPC Kunlun Gas, the company will then prepare a feasibility study for review by CNPC Kunlun Gas. The two potential gas fueled power plants in Phase I are located in Zhaoqing City and Jiangmen City, Guangdong Province, China, respectively. Phase I will include a two-kilometer (1.4 mile) pipeline and a one-kilometer (0.7 mile) pipeline for the two potential gas fueled power plants, respectively.
- On September 5, 2013, the Company entered into a natural gas purchase and sale agreement with Hainan Fuel Chemical Co., Ltd. a subsidiary of China National Offshore Oil Corporation ("CNOOC") to purchase 6.5 million cubic metres of natural gas during the remainder of 2013 (the "Additional Quota Gas"). The Additional Quota Gas was added to the Company's existing 24 million cubic metre quota for the Sanya operations allowing the company to purchase significantly reduced quantities of relatively expensive CNG and LNG to supply its operations.
- On August 26, 2013, the Company granted stock options (the "Options") to certain officers, directors, employees and consultants to acquire up to an aggregate of 3,400,000 common shares of the Company. 2,700,000 of the Options were granted to fifty-one (51) persons who were directors, officers, employees or consultants of the Company residing in China. The term of the Options is five years from the date of grant.
- On August 2, 2013, the Company 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 the Xiangdong District, Pingxiang City, Jiangxi Province, China.
- On July 2, 2013, the Company renewed its line of credit (the "Credit line") with Bank of China, Sanya Branch ("BOC") for $1.8 million (RMB 10.0 million), maturing 12 months from the date of the first withdrawal, and bearing interest of 110% of the prime rate set by the People's Bank of China and withdrew $1.8 million (RMB 10.0 million).
- In the first half of 2013, the company withdrew $3.5 million (RMB 20.0 million) from its term loan facility with the Bank of China, Pingxiang Branch ("BOC, Pingxiang "). In December 2012, the Company entered into a term loan facility with BOC, Pingxiang for $3.5 million (RMB 20.0 million), maturing six years from the date of the first withdrawal, and bearing both fixed and variable interest at 120% of the prime rate of the People's Bank of China. The variable component of interest will be calculated initially on the date of withdrawal and will be reset every three months. This term loan facility is secured by the property and equipment of Pingxiang Changfeng Natural Gas Co., Ltd., a subsidiary of the Company, and guaranteed by Sanya Changfeng Offshore Natural Gas Distribution Co., Ltd. The proceeds from this term loan facility will be used to fund the construction of pipelines and related property and equipment to be used in the Xiangdong project.
- On January 30, 2013, the Company commenced the sale of natural gas to a ceramics manufacturer in the "Park", marking the beginning of the commercial operation of the Xiangdong project.

- On January 15, 2013, the Company entered into an agreement with the Bank of China (Sanya Branch) ("BOC") to secure a bank loan facility in the amount of $8.8 million (RMB50.0 million) (the "Term Loan"). The bank loan facility provides that the proceeds of the Term Loan will be used to fund continued construction of pipeline and associated facilities of the Haitang Bay project in Sanya City. The Term Loan is secured by the same collateral as that of the existing RMB130.0 million loan facilities with BOC as announced on April 4, 2011. It has a ten-year term from the date of the initial withdrawal, and bears interest of 110% of the prime rate set by the People's Bank of China (the central bank of China). As of the date of this MD&A, the Company has withdrawn $7.0 million (RMB40.0 million).

## Business Segments

Changfeng's businesses are organized into two segments: Natural Gas Distribution Utility and CNG Refueling Retail Station.

**Natural Gas Distribution**

The Natural Gas Distribution segment consists of gas pipeline installation and connection and piped gas sales, which is currently its primary operation.

Changfeng operates by installing and connecting gas pipelines and selling gas through its pipeline networks to the end users. Changfeng currently derives the majority of its revenue from the distribution of natural gas through its pipeline networks in Sanya City, Hainan Province, China.

Since 2003, Changfeng has been building extensive pipeline networks in the main district of Sanya City. Over the last three years, Changfeng has committed significant resources to extend its gas pipeline networks from the main district of Sanya City to the Haitang Bay area, a newly developing, high growth tourist district in Sanya City. The rapid growth of the Haitang Bay district is mainly attributable to the commitment made by the China Central Government in late 2009 to build Hainan Province into an international tourism destination by 2020.

Since 2008, in order to add incremental value to its existing business, Changfeng has been actively pursuing its gas connections and pipeline gas business in selected cities in Jiangxi, Hunan, Hubei and Guangdong provinces in mainland China. These provinces represent potentially large, rapidly growing emerging-markets for Changfeng as a result of the full operation of the eight sub-lines of WEP II in 2012. Please refer to the Expansion Project section in this MD&A for further discussion of these projects.

**CNG Refueling Retail Station Segment**

CNG Refueling Retail Station serves mainly for public transportation vehicles like buses and taxis in Changsha City, Hunan Province, China. Its first CNG refueling retail station was completed and commenced the supply of gas in April 2010.

Changsha City is the capital of Hunan Province with a population of approximately 6.5 million, and it is an important commercial and trade center in central-south China. In 2006, the Changsha City municipal government began to encourage taxicab and public bus vehicles to be dual-fuel vehicles (gasoline and natural gas) in order to alleviate a serious air pollution problem. In 2012, the municipal government allowed private owners to switch to natural gas fueled vehicle.

# Selected Annual Financial Information

| *In thousands of Canadian dollars except percentages and per share amounts* | 2013 | 2012 | Change | % |
|---|---|---|---|---|
| Revenue | 42,049 | 33,273 | 8,776 | 26% |
| **Gross margin** | **19,998** | **15,755** | 4,243 | 27% |
| **% of revenue** | **47.6%** | **47.4%** | 0.2% | |
| Other operating income | - | 717 | (717) | -100% |
| General and administrative | 9,268 | 7,464 | 1,804 | 24% |
| % of revenue | 22.0% | 22.4% | -0.4% | |
| Travel and business development | 3,337 | 2,961 | 376 | 13% |
| % of revenue | 7.9% | 8.9% | -1.0% | |
| Stock based compensation | 382 | 180 | 202 | 112% |
| % of revenue | 0.9% | 0.5% | 0.4% | |
| **Total expenses** | **12,987** | **10,605** | 2,382 | 22% |
| **% of revenue** | **30.9%** | **31.9%** | -1.0% | |
| **Income before interest, equity loss and income taxes** | **7,011** | **5,867** | 1,144 | 19% |
| **% of revenue** | **16.7%** | **17.6%** | -0.9% | |
| Interest on long term debt | 1,638 | 1,453 | 185 | 13% |
| % of revenue | 3.9% | 4.4% | -0.5% | |
| Interest (income) expense | (37) | 26 | (63) | -242% |
| % of revenue | -0.1% | 0.1% | -0.2% | |
| Share of loss of investment in associate | 1.3 | 24 | (23) | -95% |
| **Income before income taxes** | **5,408** | **4,365** | 1,043 | 24% |
| **% of revenue** | **12.9%** | **13.1%** | -0.3% | |
| Income tax | 2,594 | 1,886 | 708 | 38% |
| % of revenue | 6.2% | 5.7% | 0.5% | |
| **Net income** | **2,814** | **2,478** | 336 | 14% |
| % of revenue | 6.7% | 7.5% | -0.8% | |
| **EBITDA (1)** | **9,806** | **8,006** | 1,800 | 22% |
| **% of revenue** | **23.3%** | **24.1%** | -0.7% | |
| Non-controlling interest | (123) | (30) | (93) | 309% |
| **Adjusted net income (2)** | **2,814** | **1,935** | 879 | 45% |
| % of revenue | 6.7% | 5.8% | 0.9% | |
| Basic EPS | 0.045 | 0.038 | 0.007 | 18% |
| Diluted EPS | 0.045 | 0.038 | 0.007 | 18% |
| Weighted average number of common shares outstanding - Basic | 65,196 | 66,025 | (829) | -1% |
| Weighted average number of common shares outstanding - Diluted | 65,815 | 66,025 | (210) | 0% |

Note: (1) EBITDA is identified and defined under the section "Non-GAAP Financial Measures".
(2) Adjusted net income is identified and defined under the section "Non-GAAP Financial Measures".

# Results of Operations

**Revenue**

Revenue for fiscal 2013 was $42.0 million, an increase of $8.8 million, or 26%, from $33.3 million in 2012. This increase is mainly attributable to continued gas volume growth (13%) and higher average selling prices for both its CNG refueling retail station in Changsha City and the natural gas distribution utility in Sanya City.

A summary of the customers connected, volume of gas sold in Sanya Region, and volume of gas sold by the CNG refueling retail station during 2013 as compared to 2012 is presented below:

| | **2013** | **2012** | **Change** |
|---|---|---|---|
| **1. Gas Distribution Utility Segment** | | | |
| **1.1. Sanya Operation** | | | |
| *Residential customers* | | | |
| Customers connected during the period | 19,496 | 16,222 | 3,274 |
| Total customers at the end of the period | 118,665 | 99,169 | 19,496 |
| Gas volume sold ($m^3$) during the period | 7,700,000 | 6,071,000 | 1,629,000 |
| *Commercial customers* | | | |
| Customers connected during the period | 39 | 48 | -9 |
| Total customers at the end of period | 722 | 683 | 39 |
| Gas volume sold ($m^3$) during the period | 25,930,000 | 26,262,000 | -332,000 |
| *Sub-total gas volume sold ($m^3$) during the period* | 33,630,000 | 32,333,000 | 1,297,000 |
| *Sub-total sales revenue in RMB (connection fee included)* | 200,115,959 | 174,681,818 | 25,434,141 |
| *Sub-total sales revenue in C$ (connection fee included)* | 33,519,423 | 27,669,600 | 5,849,823 |
| **1.2. Xiangdong Operation** | | | |
| *Residential customers* | | | |
| Customers connected during the period | 265 | - | 265 |
| Total customers at the end of the period | 265 | - | 265 |
| Gas volume sold ($m^3$) during the period | 6,060 | - | 6,060 |
| *Industrial customers* | | | |
| Industrial customers connected during the period | 5 | - | 5 |
| Industrial customers at the end of the period | 5 | - | 5 |
| Gas volume sold ($m^3$) during the period | 1,084,900 | - | 1,084,900 |
| *Sub-total gas volume sold ($m^3$) during the period* | 1,090,960 | - | 1,090,960 |
| *Sub-total sales revenue in RMB (connection fee included)* | 3,987,236 | - | 3,987,236 |
| *Sub-total sales revenue in C$ (connection fee included)* | 667,862 | - | 667,862 |
| Sub-total gas volume sold ($m^3$) during the period (Gas distribution utility) | 34,720,960 | - | 34,720,960 |
| Sub-total gas sales revenue in RMB (Gas distribution utility) (connection fee included) | 204,103,195 | 174,681,818 | 29,421,377 |
| Sub-total gas sales revenue in C$ (Gas distribution utility) (connection fee included) | 34,187,285 | 27,669,600 | 6,517,685 |
| | | | |
| **2. CNG Refueling Station Segment** | | | |
| 2.1. Changsha's CNG refueling retail station | | | |
| Sub-total CNG volume sold ($m^3$) during the period | 13,262,000 | 10,097,716 | 3,164,284 |
| Sub-total CNG sales revenue in RMB | 46,935,855 | 35,372,986 | 11,562,869 |
| Sub-total CNG sales revenue in C$ | 7,861,756 | 5,603,081 | 2,258,676 |
| | | | |
| **Total gas volume sold ($m^3$) during the period** | **47,982,960** | **42,430,716** | 5,552,244 |
| **Total sales revenue in RMB** | **251,039,050** | **210,054,804** | 40,984,245 |
| **Total sales revenue in C$** | **42,049,041** | **33,272,681** | 8,776,360 |

*Gas distribution utility*

Sales from the gas distribution utility for 2013 were $34.2 million, an increase of $6.5 million, or 23%, from $27.7 million in 2012. This increase was attributable to the following:

- increased gas volume sold of 33.6 million $m^3$ in the Sanya operation in 2013 compared to 32.3 million $m^3$ sold in Sanya operation in the same period of 2012;
- higher average selling prices in the Sanya operation;
- increased pipeline connection fees in the Sanya operation;
- increased gas volume sold of 1.1 million $m^3$ in the Xiangdong operation in 2013 compared to 0.0 million $m^3$ sold in the same period of 2012; and
- the appreciation of exchange rate between the Chinese RMB and the Canadian dollar.

Currently, the Company has an annual gas quota of 24.0 million $m^3$ and an uncertain amount of extra gas quota made available each year through coordination with the local government in Sanya region. In 2013, the Company entered into a natural gas purchase and sale agreement with Hainan Fuel Chemical Co., Ltd. a subsidiary of China National Offshore Oil Corporation ("CNOOC") to purchase 6.5 million $m^3$ of natural gas during the remainder of 2013. Effective November 23, 2012, the local natural gas pricing authority approved a 24% price increase for its non-residential customers in Sanya City. The selling price to its residential customers remained unchanged.

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 77% 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) potential 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 five 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 2013 was $7.9 million, an increase of $2.3 million, or 41%, from $5.6 million in 2012. The significant increase was attributable to the combined effect of the increased gas volume sold (13.3 million $m^3$ in 2013 compared to 10.1 million $m^3$ in 2012) and higher average selling prices. Effective August 13, 2012, the local natural gas pricing authority approved a 15% price increase for CNG retail stations in Changsha City as a response to a gasoline price increase. In addition, 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 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 in net income. Excluding the foreign exchange effect, revenues for fiscal 2013 were RMB 251.0 million, an increase of RMB 40.9 million (20%), from RMB 210.1 million in 2012.

The exchange rate between the Chinese RMB and the Canadian dollar is summarized below.

| One Chinese RMB to Canadian dollars | 2013 | 2012 | % change |
|---|---|---|---|
| Spot rate at the end of the year | 0.1757 | 0.1597 | 10.0% |
| Average rate for the year | 0.1675 | 0.1584 | 5.7% |

**Gross margin**

Gross margin for 2013 was $20.0 million, an increase of $4.2 million, or 27%, from $15.8 million in 2012. The gross margin percentage of 48% for 2013 is approximately the same as for 2012.

Gas distribution utility gross margin as a percentage of sales year-over-year improved 1% (53% for 2013 VS 52% for 2012) 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 CNG refueling station gross margin as a percentage of sales year-over-year increased 3% (25% for 2013 VS 22% for 2012) primarily to selling price increases and lower operating costs as a result of gas volume increase.

**Other operating income**

Other operating income for 2013 was 0.0 million, compared to $0.7 million in 2012. On June 27, 2012, the Company received a $0.7 million government grant from the municipal government of Sanya City to partially compensate the Company for certain 2011 gas purchases made at unfavorable prices in order to satisfy customer demand in the Sanya region.

**Operating expenses**

**General and administrative expenses** for 2013 were $9.3 million, an increase of $1.8 million, or 24%, from $7.5 million in 2012. The increase was attributable to higher employee salaries and benefits as a result of a higher inflation rate in China, additional employees, and higher conference and professional fees. General and administrative expenses as a percentage of sales for 2013 were 22% is approximately the same as for 2012.

**Travel and business development expenses** for 2013 were $3.3 million, a increase of $0.4 million, or 13%, from $2.9 million in 2012. As a percentage of sales, travel and business development expenses for 2013 was 8%, a decrease from 9% in 2012. 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 fiscal 2013 and 2012 was $1.6 million and $1.5 million, respectively, an increase of $0.1 million. The increase is due to additional long-term loans obtained by the Company in the fourth quarter of 2012 and that of 2013.

**EBITDA**

EBITDA (non-GAAP measure as identified and defined under section "Non-GAAP Measures") for fiscal 2013 was $9.8 million, an increase of $1.8 million, or 22%, from $8.0 million for 2012. The increase was driven primarily by higher sales. EBITDA as a percentage of revenue for 2013 was 23%, compared to 24% in the same period in 2012. This decrease is largely attributable to the other operating income earned in 2012.

**Net income**

Net income for fiscal 2013 was $2.8 million, or $0.045 per share (basic and diluted) compared to $2.5 million or $0.038 per share (basic and diluted) in 2012.

***Adjusted net income***

Adjusted net income (non-GAAP measure as identified and defined under section "Non-GAAP Measures") for fiscal 2013 was $2.8 million, compared to $1.9 million for the same period in 2012 as increase of 45%.

## Expansion Projects

Changfeng has the following projects under development as part of its growth strategy.

**Haitang Bay Pipelined Gas Project, Sanya City, Hainan Province**

Haitang Bay is one of the five major bays in Sanya City, Hainan province. It is a flagship project being promoted by the Hainan provincial government to build Hainan Island into an international tourism destination by 2020. The size of the Haitang Bay development area is estimated at 98.7 square km and includes approximately 24 km of beachfront. It is planned to build this area into a new township and house more than twenty (20) five-star hotels by 2020.

In December 2010, Changfeng completed the extension of a 26.6 km of high-to-medium pressure pipeline linking Sanya City with Haitang Bay district together with 21.2 km of low pressure pipeline and associated facilities, and began to supply gas for this district.

During 2013, the construction of pipeline networks in this district was slowed due to the tightening of credit by the Central Government of China to address growing inflation in China. In the long term, Changfeng believe that the Haitang

Bay would represent a high-growth potential area for its operation in Sanya Region as more luxury hotels are to be constructed and connected to its pipeline networks.

Currently, there are seven newly built hotels, including the Hilton, and Sheraton-chains, in operation and using the natural gas supplied by the Company for cooking and hot water. The gas consumption in 2013 was 3.3 million cubic meters, accounting for 10 percent of the total gas sales in Sanya operation.

**CNG Refueling Retail Stations Project, Changsha City, Hunan Province**

CNG refueling stations represent Changfeng's first growth project in mainland China. However, further expansion and development of CNG refueling retail stations in Changsha beyond the first station has been delayed pending a secured gas source at a price that will provide a reasonable margin. In addition, other issues such as pricing of the lands to be either leased or purchased for construction of the CNG refueling stations, market size/development and capital budgeting are expected to play a role in the evolution of its CNG station initiative in Changsha City.

**CNG and Piped Gas Distribution-Project, Xiangdong district, Pingxiang City, Jiangxi Province**

In January 2013, the Company completed the pre-operational inspection and safety testing for the Xiangdong project and commenced the sale of natural gas to a ceramics manufacturer in the "Park", marking the beginning of the commercial operation of the Xiangdong project. The gas quota as previously announced on November 23, 2011 will be saved and accumulated until the Company can access the gas from the WEP II. In August 2013, the Company 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 the Xiangdong District, Pingxiang City, Jiangxi Province, China.

**CNG and Pipelined Gas Project, Xiangtan City, Hunan Province**

On July 19, 2011, Changfeng established a 51%-owned company Xiangtan Changfeng Xiangtan Natural Gas Co., Ltd. ("Xiangtan CF"), together with a company owned by the local municipality, Xiangtan Economic Construction and Development Investment Co. Ltd. and a local investment company, to jointly develop potential pipelined gas business, CNG and LNG refueling stations in designated regions of Xiangtan City. Currently, Changfeng are working on the feasibility study of the potential projects.

**Investment in Associate**

In October 2011, Changfeng, together with Xiangtan Economic and a Zhuhai Hailian Investment Co., Ltd., a private investment company, established Xiangtan Shin-Ko Energy Co., Ltd. ("Shin-Ko Energy") with a total registered capital of $1.8 million (RMB 10.0 million), of which the Company owns 50%. The objective of Shin-Ko Energy is to develop and invest in urban natural gas utilization in Xiangtan City, Hunan Province, China. As of December 31, 2013, Changfeng contributed its share of registered capital of $0.4 million (RMB 2.0 million). Currently, Shin-Ko Energy is working towards satisfying certain regulatory requirements such as the project design, project safety assessment and environmental impact assessment, all of which are required to be submitted prior to the commencement of construction. Shin-Ko Energy is also working with the local government to secure both the location and purchase price of the land for the project.

**Pipelined Gas Project, in the Western Guangdong Area ("Yue Xi") of Guangdong Province, China**

In the third quarter of 2013, the Company has identified two gas fueled power plants as its phase I targeted customers ("Phase I"). The Company intends to establish a joint venture with PetroChina Kunlun Gas Co., Ltd ("CNPC Kunlun Gas"), a wholly owned subsidiary of PetroChina, to build high pressure transmission pipelines and associated facilities (the "Pipelines") to link the existing and/or planned provincial trunk lines to certain gas fueled power plants located in Guangdong Province, China.

The Company filed a feasibility study on the first potential gas fueled power plant in Phase I with CNPC Kunlun Gas and is now reviewing CNPC Kunlun Gas' feedback and preparing a revised feasibility study which will be submitted shortly.

The Company has also submitted an initial project proposal on the second potential gas fueled power plant in Phase I to CNPC Kunlun Gas for its review. If the initial project proposal is accepted by CNPC Kunlun Gas, the company will then prepare a feasibility study for review by CNPC Kunlun Gas.

The two potential gas fueled power plants in Phase I are located in Zhaoqing City and Jiangmen City, Guangdong Province, China, respectively. Phase I will include a two-kilometer (1.4 mile) pipeline and a one-kilometer (0.7 mile) pipeline for the two potential gas fueled power plants, respectively.

## Selected Quarterly Results

The following sets out the Company's consolidated quarterly results for the most recent eight quarters:
In thousands of Canadian dollars, except per share amounts:

| Quarterly data ($000's) | 2013 | | | | 2012 | | | |
|---|---|---|---|---|---|---|---|---|
| except per share amounts | Q4 | Q3 | Q2 | Q1 | Q4 | Q3 | Q2 | Q1 |
| Foreign exchange rate one Chinese RMB to Canadian dollars | 0.1675 | 0.1660 | 0.1642 | 0.1621 | 0.1584 | 0.1564 | 0.1595 | 0.1587 |
| Revenue | 12,996 | 10,240 | 9,190 | 9,623 | 10,857 | 7,929 | 7,122 | 7,365 |
| Gross margin | 5,230 | 4,867 | 4,326 | 5,575 | 5,112 | 3,218 | 3,472 | 3,953 |
| Interest | 316 | 443 | 437 | 442 | 313 | 367 | 387 | 386 |
| Net income (loss) | 345 | 571 | 625 | 1,273 | 771 | 55 | 826 | 826 |
| Net income (loss) per share | | | | | | | | |
| - basic | 0.005 | 0.010 | 0.010 | 0.020 | 0.011 | 0.001 | 0.013 | 0.013 |
| - diluted | 0.005 | 0.010 | 0.010 | 0.020 | 0.011 | 0.001 | 0.013 | 0.013 |

## Financial Condition and Liquidity

| Key Financial Data and Comparative Figures | | |
|---|---|---|
| ($000's) | 31-Dec-13 | 31-Dec-12 |
| Cash | 15,151 | 6,377 |
| Working capital (deficit) | (9,465) | (12,205) |
| Adjusted working capital (note1) | 8,375 | 1,497 |
| Plant and equipment | 57,311 | 46,247 |
| Total assets | 83,637 | 61,200 |
| Long term liabilities | 32,495 | 21,620 |
| Shareholders' equity | 20,540 | 16,068 |

Notes: (1) These financial measures are identified and defined under the section "Non-GAAP Financial Measures".

Cash increased by $8.8 million to $15.2 million at December 31, 2013 from $6.4 million at December 31, 2012, primarily resulting from cash provided during 2013 by operating activities of $10.0 million and new withdrawal of $13.3 million from loan facilities, offset by cash used during 2013 for capital expenditure of $9.3 million and $5.0 million repayment on line of credit and $0.8 million repayment of long-term debt, and $0.5 million for share buyback.

**Adjusted Working Capital**

Its adjusted working capital (see "Non-GAAP Financial Measures") was $8.4 million at December 31, 2013. Adjusted working capital excludes $14.5 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 sources of long-term funding are its three term loans into which Changfeng 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 $3.5 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 will be 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 report, the Company withdrew $3.5 million (RMB 20.0 million).

On January, 15, 2013 the Company entered an agreement with BOC, Sanya Branch to secure a bank loan facility in the amount of $8.8 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. The Term Loan is secured by the same collateral as that of the existing term loan and the Credit Line described in note 13(a)(ii) and 13(b)(i) of the Consolidated Financial Statements, respectively. 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 $7.0 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.

*Government grants*

In 2013, the Company also received government grants of $93,268 (RMB 530,834) (2012 - $811,276 (RMB 5,080,000)) to fund the construction of certain items of property and equipment for the Company's operation in Sanya City. These government grants were recognized as a long-term liability and will be recognized in net income over the expected useful life of the related assets when the related assets are ready for use.

*2013 Credit Agreement*

Included in current liabilities is $1.8 million (RMB 10 million) (December 31, 2012 - $4.8 million (RMB 30 million)) relating to the Company's Line of Credit (the "Credit Line") with BOC, Sanya. This loan contains a financial covenant, which requires the Company's subsidiary CF China's debt-to-total-assets ratio to be maintained below 80%. In the first and second quarters of 2013, the Company had fully repaid its $5.3 million (RMB 30 million) line of credit with BOC. In the third quarter of 2013, the Company renewed its line of credit with BOC for $1.8 million (RMB 10 million). As of December 31, 2013, the Company had withdrawn $1.8 (RMB 10 million) (December 31, 2012 - $4.8 (RMB 30 million)).

Also included in current liabilities is $1.6 million (RMB 9 million) (December 31, 2012 -$0) relating to a US$1.5 million term loan from the Bank of China (Canada) pursuant to a Credit Facility Letter Agreement effective October 30, 2013. The Term Loan is secured by a Standby Letter of Credit provided by the Company and issued by the Bank of China Hainan Branch for the amount of RMB 10 million. The Term Loan has a one-year term from the date of the withdrawal and bears annual interest of 6-month LIBOR Rate plus 250bps.

*Cash Flow from Operations*

Net cash provided by operations was $10.0 million for fiscal 2013 compared to $8.4 million in 2012.

*Cash Flow from Financing Activities*

Cash provided by financing activities in 2013 included a $10.0 million withdrawal from the term loan facility and $3.3 million from line of credit, offset by the short term loan payment of $5.0 million, $0.8 million term loan principal payment and $0.5 million paid for the share buyback.

*Investing Activities*

Cash used in investing activity included capital expenditures of $9.3 million for fiscal 2013 compared to $6.3 million in 2012. 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 the BOC and BOC, Pingxiang, as well as operating cash flow from its existing operations.

## Contractual Obligations and Commitments

**Pipeline Construction and Equipment:**

The Company has signed contracts with several equipment suppliers and construction supervisors for a total amount of 8.5 million (RMB 48.4 million), of which $5.5 million (RMB 31.4 million) has been paid as at December 31, 2013.

**Natural Gas Purchase Commitments:**

The following tables summarize its contractual obligations and commitments as of December 31, 2013 in connection with its natural gas purchase contracts:

| Year | Gas source supplier | Gas volume quota | Location |
|---|---|---|---|
| 2006-2015 | Ya13-1 Gas Well (CNOOC) | 24 million $m^3$ a year | Sanya city |
| 2010-2015 | Shennan LNG | LNG unlimited supply is variable within Changfeng's forecast demand | Sanya city |
| 2011-2015 | Chengmaisanyou CNG | Maximum of 5 million $m^3$ a year, | Sanya city |
| 2015 and beyond | Yangpu LNG Receiving terminal (CNOOC) | Letter of intent for up to 150 million $m^3$ a year | Sanya city |

**Lease Commitment:**

On September 28, 2010, the Company signed a land lease agreement for the construction of its second CNG refuelling station in Changsha City, Hunan Province. The lease term is for 21 years, ending September 27, 2035. Upon signing the agreement, the Company paid a deposit of $0.02 million (RMB 0.1 million), which is expected to be refunded when the agreement expires. The first year's rent of $0.06 million (RMB 0.3 million) is required to be paid upon commencement of construction. As at December 31, 2013, construction of the refueling station had not commenced.

The minimum lease payments in successive years are as follows:

| | RMB | Cdn. $ |
|---|---|---|
| 2014 | 493,500 | 86,708 |
| 2015 | 829,500 | 145,743 |
| 2016 | 833,613 | 146,466 |
| 2017 | 854,175 | 150,079 |
| 2018 | 854,175 | 150,079 |
| Thereafter | 13,112,054 | 2,303,788 |
| | 16,977,017 | 2,982,863 |

Other obligations and commitments are incurred in the normal course of business operations.

## 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.

## Related Parties Transactions

- As at December 31, 2013, the Company had an outstanding loan of $0.4 million (RMB 2.0 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 loan is unsecured and non-interest bearing. 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 prescribed by the People's Bank of China.

- Included in current due to related parties as at December 31, 2013, is a required capital contribution of $0.5 million (RMB 3.0 million) (December 31, 2012 - $0.5 million (RMB 3.0 million in long-term)) to be made to Shin-Ko Energy. Also, included in current due to related parties as at December 31, 2013, was $0.2 million (RMB1.3 million) (2012 - $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.
- In 2007, a significant shareholder, who is also an officer and director of the Company, advanced loans in the aggregate amount of $7 million (RMB 40 million) (December 31, 2012 - $6.4 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. The Company has not made any repayments in 2013, which are due on April 27, 2015.
- As at December 31, 2013, the Company has made a lump sum payment to an officer and director of the Company for the outstanding salary and director's fees of $0.6 million (2012 - $0.5 million).
- As at December 31, 2013, the Company owed certain directors $0.07 million (2012 - $0.05 million) for unpaid director's fees.
- During 2013, one of the predecessor officers exercised 200,000 share options granted under the Company's stock option plan at the exercise price of $0.23.

## Share Capital

As of the date of this MD&A, the Company has 63,559,200 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 2013, the Company purchased for cancellation 1,585,800 of its common shares under its normal-course issuer bid (the "Bid") for cash of $537,019. These shares were cancelled automatically after the company purchased them. Subsequent to December 31, 2013, the Company purchased 1,080,000 shares pursuant to the Bid for cash of $421,779.

## Risks and Uncertainties

The Company is exposed to a variety of risks in the normal course of operations that could significantly affect its operating cash flow and profitability of operations and could cause its actual results to differ in material respects from its anticipated results. These risks may include, but are not limited to, those listed below. The Company seeks to manage the risks associated with its business operations; however, many of the factors affecting these risks are beyond the Company's control. The future effect of these risks and uncertainties cannot be quantified or predicted.

**Country risks**

As substantially all of the business of the Company is operated in China, the profitability, financial position and prospects of the Company are subject to the consideration and risks of operating in China. These include risks associated with the political and economic environment, foreign currency exchange and the legal system in China. Any changes in the policies of the Chinese government regarding the domestic economy (for example, changes affecting foreign exchange rates, inflation, taxation and trade) may have a material effect on the overall economy.

The Chinese government has been pursuing economic reforms since it first adopted its "open-door" policy in 1978. The current reforms are unprecedented, producing effects that are unpredictable, and are subject to further refinement and improvement. New political, economic and social developments and considerations may lead the Chinese government to make adjustments to these reform measures. Any change in governmental policies or any unfavourable change in the political, economic or social conditions, the laws or regulations, or the rate or method of taxation in China may have a material adverse effect on the business of the Company.

Many laws and regulations dealing with economic matters in general, and foreign investment in particular, have been enacted in China. However, China still does not have a comprehensive system of laws, and enforcement of existing laws may be uncertain and sporadic. In China, gas distribution companies invest in and operate the piped gas supply business in urban areas under the supervision of a number of government ministries and departments, including the Ministry of Commerce, the Ministry of Labor and Social Security and the Ministry of Public Security. The Company must comply with the relevant requirements of certain regulations, including the City Fuel Gas Administration Regulations, the Tentative Regulations in relation to the Supervision and Administration of the Safety of Petroleum and Natural Gas

Pipelines and the Regulations of the Safety of City Fuel Gas Administration. In addition, the Company must comply with the relevant requirements and policies of local authorities where the Company's projects are situated. Rights or rights of first refusal to provide piped gas are granted by local governments pursuant to policies of promoting environmental protection and encouraging the use of natural gas and the construction of natural gas supply facilities. In addition, the natural gas distribution business in China is highly regulated and pricing is controlled by the Chinese government. Any change in such laws or regulations could have a material adverse effect on the business of the Company. There can be no assurance that the above regulatory regime and policies (including the granting of rights or rights of first refusal to supply piped gas) will not be changed. The Company's operations and profitability may be materially adversely affected if changes that occur are not favorable to the Company.

**Changes in foreign exchange regulations**

Since 1996, the Chinese government has promulgated various foreign exchange rules, regulations and notices (the "Policies") to raise the convertibility of the Chinese renminbi ("renminbi"). According to the Policies, a foreign-invested enterprise ("FIE") must open a "current account" and a "capital account" at a bank authorized to trade foreign exchange. A FIE may convert renminbi in the capital account into any foreign currency at any authorized bank with the prior approval of the State Administration for Foreign Exchange ("SAFE") . The income and expenditures of the Company are denominated in renminbi. At present, renminbi cannot be freely converted into other currencies. According to the Polices, upon producing the board resolution on the authorization of the distribution of profits or dividends or the commercial documents evidencing foreign exchange transactions, the Company may purchase the foreign exchange required for the distribution from a designated authorized bank. The Company cannot guarantee that the Policies will not be withdrawn or amended. The Company continues to have substantial requirements for foreign currency, including foreign currency denominated loans and purchases of imported equipment and materials. Repayment of the principal and interest on loans denominated in foreign currency shall be approved by SAFE in advance. Such approval requirements could affect the Company's ability to obtain foreign exchange through debt financing or to obtain foreign exchange for capital expenditure. In addition, according to the current foreign exchange control system, there can be no assurance that sufficient foreign exchange can be obtained pursuant to a specific exchange rate in order to satisfy the Company's needs. A shortage in the foreign exchange may prevent the Company from obtaining sufficient currency to pay dividends or limit its ability to satisfy its needs for foreign exchange.

**Development projects and acquisitions**

Changfeng continues to focus on growing its business segments through organic development projects or acquisitions. The Company capitalizes costs incurred on certain of its projects during the development period when the project meets specific criteria and is expected to proceed through to completion. The related capital costs of a project that does not proceed through to completion are expensed at the time it is discontinued to the extent that these costs and underlying materials cannot be utilized on another project. With respect to the Company's acquisition of assets and operations, there is a risk that certain business opportunities may not materialize as expected, resulting in asset impairment.

**Substantial initial capital expenditure requirement**

The nature of the Company's operations require it to make a substantial initial investment in the construction of gas pipeline infrastructure and the construction of CNG filling stations. The initial investment must be financed by internal resources of the Company, bank loans and/or equity fund raising. There can be no assurance that external sources of financing will be available to fund the Company's capital expenditure program. The failure to obtain such financing may hinder the Company's ability to continue its existing investments or make new investments. In addition, there are risks associated with the construction of new facilities, including risks that costs of construction may be greater than anticipated, and that construction may be delayed due to factors beyond the control of the Company.

**Grant of additional licenses**

The business objectives of the Company include the expansion of its operations by applying for distribution and construction permits for natural gas distribution rights in other cities in China. Applicants for such licenses are required to meet extensive criteria, and to submit to a detailed examination of their infrastructure and management to a special team appointed by the government body reviewing such applications. Notwithstanding the results of any such review, distribution and construction permits are granted to applicants at the sole discretion of the government body reviewing such applications, and such grants occur on an infrequent basis. Accordingly, there can be no assurance that the Company will be granted any distribution or construction permits for which it applies, which may in turn have a material adverse effect upon the operations and growth strategy of the Company.

**Price control**

Any increase in gas usage charges exceeding the original approved charge requires the approval of the local state price bureau. There is no assurance that any increases (except for an increase to offset the rise in the Company's purchase price of gas) will be approved. There is no assurance that the Company will be able to offset any increase in the purchase price of gas with an increase in the sales price, such that its profitability may be adversely impacted.

**Obligations to purchase gas**

The Company currently has a letter of intent with CNOOC for the purchase of 150 million $m^3$. The Company may, at its option, enter into a take or pay agreement with CNOOC which will leave it financially committed to purchase gas without any assurance that it will have sales to offset the purchase obligations. In addition, the agreement in principle between the Company and CNOOC is conditional upon the completion of a plant to be constructed by CNOOC, which is in turn subject to the receipt of various regulatory and governmental approvals. Failure by CNOOC to obtain the required approvals and/or to complete construction of its proposed plant may have a material adverse effect on the Company.

**Reliance on the suppliers of natural gas**

At present, the Company purchases natural gas solely from Hainan Petrol pursuant to the supply agreement. Currently, the Company has a contract to purchase 24 million $m^3$ gas a year from this supplier until December 31, 2015. There can be no assurance that the Company will be able to obtain natural gas from suppliers on terms similar to those of the supply agreement or without material interruption.

**Limited insurance coverage**

As natural gas is an inherently flammable and explosive substance, the Company has implemented strict safety measures for the operation and maintenance of its facilities; however, the Company cannot guarantee that industry-related accidents will not happen in the future. Significant operational hazards and natural disasters may cause interruptions in the Company's operations that could have a material adverse impact on the financial condition of the Company. Although the Company may maintain insurance to protect against certain risks in such amounts as considered reasonable, its insurance will not cover all the potential risks associated with its operations. The Company may also be unable to maintain insurance to cover these risks at economically feasible premiums. Insurance coverage may not be available or may not be adequate to cover any resulting liability. A successful claim made against the Company that is not covered by any of the Company's insurance policies or is in excess of its insurance coverage could have a material adverse effect on the Company's business and financial position.

**Environmental risks and hazards**

All phases of the Company's operations are subject to environmental regulation in the jurisdictions in which it operates. Environmental legislation is evolving in a manner that will require stricter standards and enforcement, increased fines and penalties for non-compliance, more stringent environmental assessments of proposed projects, and a heightened degree of responsibility for companies and their officers, directors and employees. There is no assurance that future changes in environmental regulation, if any, will not adversely affect the Company's operations. Environmental hazards may exist in connection with the pipelines and distribution networks in which the Company holds interests that are unknown to the Company at present. Government approvals and permits are currently, and may in the future, be required to be obtained or renewed in connection with the Company's operations. To the extent such approvals are required and not obtained or existing permits are not renewed, the Company may be curtailed or prohibited from continuing its operations or from proceeding with planned development of its proposed projects. Failure to comply with applicable laws, regulations and permitting requirements may result in enforcement actions thereunder, including orders issued by regulatory or judicial authorities causing operations to cease or be curtailed, and may include corrective measures requiring capital expenditures, installation of additional equipment, or remedial actions. The Company may be required to compensate those suffering loss or damage by reason of its activities and may have civil or criminal fines or penalties imposed for violations of applicable laws or regulations. Amendments to current laws, regulations and permits governing current or proposed operations and activities of the Company, or more stringent implementation thereof, could have a material adverse impact on the Company and cause increases in development expenses, capital expenditures or production costs, or require abandonment or delays in development of new projects. The Company is subject to the Chinese environmental protection laws and regulations which impose fines for violations of laws, regulations or decrees and provide for the shutdown by the central, provisional or municipal governments of any facility not in compliance with governmental orders requiring the cessation or cure of certain activities causing environmental damage. As natural gas is an environmentally friendly form of fuel, the Company has not adopted any special environmental protection measures other than the measures taken in the ordinary course of business by companies in the industry.

**Key executives**

The Company is dependent upon the services of key executives, management of the Company and a small number of highly-skilled and experienced executives and personnel. In addition, in the event that the Company expands its operations to other jurisdictions in the Hainan and Guangdong Provinces as presently contemplated, it will be required to hire additional skilled personnel. Due to the relatively small size of the Company, the loss of these persons or the

Company's inability to attract and retain additional highly-skilled employees may adversely affect its business and future operations.

**Infrastructure**

Natural gas distribution activities depend on adequate infrastructure. Reliable roads, bridges, power sources and water supply are important determinants, which affect capital and operating costs. Unusual or infrequent weather phenomena, sabotage, government or other interference in the maintenance or provision of such infrastructure could adversely affect the Company's operations, financial condition and results of operations. Any increase in the operating costs of the natural gas distribution networks of the Company could have a material adverse effect on the Company.

**Competition**

The natural gas distribution industry is competitive in all of its segments. The Company faces strong competition from other natural gas distribution companies in connection with the development of pipelines and acquisition of distribution rights for natural gas. Many of these companies have greater financial resources, operational experience and technical capabilities than the Company. As a result of this competition, the Company may be unable to maintain or acquire distribution rights on terms it considers acceptable, or at all. The ability of the Company to acquire natural gas distribution rights depends upon whether the Company is able to meet certain qualifications, the extent of competition, and the discretion of the MCC and other applicable government bodies. Factors beyond the control of the Company may affect its ability to obtain or retain distribution rights, or to secure exclusive concession rights with local municipalities, as well as the marketability of natural gas distributed by the Company. As a result of these and other factors, competitors of the Company may be granted shared or exclusive natural gas distribution rights in the target markets of the Company, either of which may adversely affect the Company's future growth plans and operations. Changfeng also competes for financing with other companies, many of whom have greater financial resources and/or more advanced operations. There can be no assurance that additional capital or other types of financing will be available if needed or that, if available, the terms of such financing will be favorable to the Company.

**Substitute products**

Coal, gas, liquid propane gas, liquid natural gas and electricity are the main substitutes for natural gas. Ultimate consumers will consider factors such as cost, reliability, convenience and safety when choosing a fuel. Connection fees, gas usage charges and heat content are the major factors affecting customers' choice of fuel. Save for newly built residential apartments that are required to be equipped with natural gas supply for cooking stoves, in most of the locations in which the Company has established a presence, there is no assurance that existing fuel users will shift to use piped natural gas. Continued growth of the Company is dependent upon the continued conversion by Chinese residential and business consumers to natural gas as a fuel source.

**Commodity prices**

The price of the securities of the Company, the Company's financial results and development activities may in the future be significantly and adversely affected by declines in the price of natural gas and other commodities. The price of natural gas and other commodities fluctuates widely and is affected by numerous factors beyond the Company's control, such as the sale or purchase of natural gas by various central banks and financial institutions, interest rates, exchange rates, inflation or deflation, fluctuation in the value of the ( "US") dollar and other foreign currencies, global and regional supply and demand, the political and economic conditions of major oil-producing countries throughout the world, and the cost of substitutes, inventory levels and carrying charges. Future serious price declines in the market value of natural gas and other commodities could cause continued development of the Company's projects to be impracticable. Depending on the price of natural gas and other commodities, cash flow from operations may not be sufficient and the Company could be forced to discontinue development of, may lose its interest in, or may be forced to sell, some of its interests.

**Currency, interest rate and exchange fluctuations**

The value of renminbi is subject to changes in the Chinese government's policies and depends to a large extent on domestic and international economic and political developments, as well as supply and demand in the local market. Since 1994, the official exchange rate for the conversion of the renminbi to US dollars has generally been stable, and renminbi has appreciated slightly against the US dollar. Any devaluation of renminbi may adversely affect the value of, and dividends payable on, the securities of the Company in foreign currency terms since the Company receives its revenues in renminbi. Results of operations and the financial condition of the Company may also be affected by changes in the value of certain currencies other than renminbi in which the Company's obligations are denominated. In particular, a devaluation of the renminbi is likely to increase the portion of the Company's cash flow required to satisfy its foreign currency-denominated obligations.

**Government regulation**

The construction and distribution activities of the Company are subject to various laws governing development, construction, distribution, taxes, labour standards and occupational health, toxic substances, land use, water use, and other matters. Although the Company's operations are currently carried out in accordance with all applicable rules and regulations, no assurance can be given that new rules and regulations will not be enacted or that existing rules and regulations will not be applied in a manner that could limit or curtail production or distribution activities. Amendments to current laws and regulations governing natural gas distribution and related matters or more stringent implementation thereof could have a substantial adverse impact on the Company.

## Non-GAAP 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 provide 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 as follows:

| In thousands (except for % figures) | 2013 | 2012 | Change | % |
|---|---|---|---|---|
| Net Income | 2,814 | 2,478 | 336 | 14% |
| Add (less): | | | | |
| Income tax | 2,594 | 1,886 | 708 | 38% |
| Interest (income) expense | (37) | 26 | (63) | -242% |
| Share of loss of investment in associate | 1 | 24 | (23) | -95% |
| Stock-based compensation | 382 | 180 | 202 | 112% |
| Amortization | 2,414 | 1,959 | 455 | 23% |
| Interest on borrowing | 1,638 | 1,453 | 185 | 13% |
| EBITDA | 9,806 | 8,006 | 1,800 | 22% |

**Adjusted net income**

Adjusted net income is calculated as net income before other operating income. Other operating income represents a government grant received by the Company. There is no guarantee that the Company will receive this government grant every year. Changfeng believes that adjusted net income is a useful supplemental measure of the Company's operating results.

The calculation of adjusted net income is provided in the table below:

| *In thousands of Canadian dollars except percentages and per share amounts* | 2013 | 2012 |
|---|---|---|
| Net income | 2,814 | 2,478 |
| Less: Other operating income, net of tax | - | 543 |
| **Adjusted net income** | **2,814** | **1,935** |

**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.

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

| **In $ thousands**<br>**As at** | **31-Dec-13** | **31-Dec-12** |
|---|---|---|
| Current assets | 21,137 | 11,306 |
| Less: Current liabilities | 30,603 | 23,511 |
| Working capital (deficit) | (9,466) | (12,205) |
| Add: Deferred revenue | 14,489 | 8,911 |
| Line of credit | 3,352 | 4,791 |
| **Adjusted working capital** | **8,375** | **1,497** |

## Financial Instruments

Changfeng 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 the notes to the Consolidated Financial Statements. See the "Note to the Consolidated Financial Statements" for further details around these contracts.

## Critical Accounting Policies and Estimates

To prepare financial statements that conform to IFRS, Changfeng is required to make estimates and assumptions that affect both the amount and timing of recording assets, liabilities, revenues and expenses, since the determination of these items may be dependent on future events. Each of these estimates varies with respect to the level of judgment involved and the potential impact on the Company's reported financial results. Estimates are deemed critical when the Company's financial condition, change in financial condition or results of operations would be materially impacted by a different estimate or a change in estimate from period to period. By their nature, these estimates are subject to measurement uncertainty, and changes in these estimates may affect the consolidated financial statements of future periods.

All of the Company's significant accounting policies are discussed in Note 3 of the Audited Consolidated Financial Statements, which are incorporated by reference and can be found on the regulator's web site at www.sedar.com

**Critical Accounting Estimates**

***Revenue recognition***

Gas connection revenue is deferred and only recognized when the outcome of a contract can be estimated reliably and the stage of completion at the balance sheet date can be measured reliably.

Revenue from gas connection contracts is recognized on the percentage of completion method, measured by reference to the value of work carried out during the year. When it is probable that total contract costs will exceed contract revenue, the expected loss is recognized as an expense immediately. Sales of gas appliances are recognized when goods are delivered and title has passed.

***Amortization expense***

The Company's plant and equipment are amortized on a straight-line basis over their estimated useful lives once they are ready for their intended use. The estimation of useful lives requires management's judgment regarding the period of time the assets will be in use based on engineering studies, experience and industry practice.

Plant and equipment are recorded at cost. Land use rights are recorded at cost and amortized over the term of the agreement. The useful lives of the Company's assets are as follows:

| | |
|---|---|
| Buildings | 30 - 35 years |
| Pipelines | 30 - 35 years |
| Land use rights | Term of agreement |
| Motor vehicles | 3 - 10 years |
| Furniture and equipment | 3 - 20 years |
| Leasehold improvement | Term of agreement |

***Impairment evaluation***

The Company assesses intangible assets with indefinite lives for impairment annually or when an event or change in circumstances may indicate impairment. This assessment includes a comparison of the carrying value of the indefinite life intangible asset to its estimated fair value to ensure that the fair value is greater than the carrying value. The Company calculates the estimated fair value using valuation methods such as discounted cash flow analysis. These valuation methods employ a variety of assumptions, including future revenue growth, expected earnings, and earnings multiples. Estimating the fair value of an indefinite life intangible asset is a subjective process and requires the use of its best estimates. If its estimates or assumptions change from those used in its current valuation, Changfeng may be required to recognize impairment losses in future periods.

The Company assesses the carrying value of long-lived assets, which include property, plant and equipment and intangible assets subject to amortization, for indications of impairment when events or circumstances indicate that the carrying amounts may not be recoverable from estimated future cash flows. Estimating future cash flows requires assumptions about future business conditions and technological developments. Significant, unanticipated changes to these assumptions could require a provision for impairment in the future.

***Income taxes***

The Company uses the asset and liability method of accounting for income taxes. Under this method of tax allocation, current income taxes are recognized for the estimated taxes payable for the current year. Future income taxes are determined based on the temporary differences between the accounting and tax bases of assets and liabilities, as well as for the benefit of losses available to be carried forward to future years for tax purposes that are more likely than not to be realized. These income tax assets and liabilities are measured using the enacted or substantively enacted tax rates in which the income tax assets or liabilities are expected to be settled or realized. A valuation allowance is provided to the extent that it is more likely that future income tax assets will be realized.

According to the PRC Tax Administration and Collection Law, the statute of limitations is three years if the underpayment of taxes is due to computational errors made by the taxpayer or the withholding agent. The statute of limitations is extended to five years under special circumstances, which are not clearly defined. There is no statute of limitations in the case of tax evasion. The tax returns of the Company's PRC subsidiaries for the 2010 tax year are subject to examination by the relevant tax authorities.

***Share-based payments:***

The Company measures the cost of equity-settled transactions with employees by reference to the fair value of the equity instruments at the dates at which they are granted. Determining fair value for share-based payment transactions requires the use of the most appropriate valuation model, which is dependent on the terms and conditions of the grant. The determination of fair value requires estimating the expected life of the share option, volatility and dividend yield.

## Future Accounting Changes

Certain pronouncements were issued by the IASB or the IFRS Interpretations Committee that are not yet effective for the year ended December 31, 2013, and have not been applied in preparing these consolidated financial statements:

**Financial Instruments - Recognition and Measurement**

In October 2010, the IASB published amendments to IFRS 9, Financial Instruments ("IFRS 9 (2010)"), which provide added guidance on the classification and measurement of financial liabilities. IFRS 9 (2010) supersedes IFRS 9 (2009) and is effective for annual periods beginning on or after January 1, 2015, with early adoption permitted. For annual periods beginning before January 1, 2015, either IFRS 9 (2009) or IFRS 9 (2010) may be applied. The Company intends to adopt IFRS 9 (2010) in its consolidated financial statements for the annual period beginning on January 1, 2015. The extent of the impact of adoption of IFRS 9 (2010) has not yet been determined.

**Financial Assets and Liabilities**

In December 2011, the IASB published amendments to lAS 32, Financial Instruments -Presentation ("IAS 32"). The amendments to lAS 32 clarify when an entity has a legally enforceable right to offset as well as clarify when a settlement mechanism provides for net settlement or gross settlement that is equivalent to net settlement. The effective date for the amendments to lAS 32 is annual periods beginning January 1, 2014. The Company intends to adopt the amendments to lAS 32 in its financial statements for the annual period beginning January 1, 2014. The extent of the impact of adoption of the amendments to lAS 32 has not yet been determined.

## Outlook

The outlook for 2014 is very 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. The Company also expects a positive impact on its 2014 earnings and operating cash flows due to the higher sales prices.

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 as discussed in the Expansion Project section in this MD&A on page 11.