# Yangarra Resources Ltd.
## Management's Discussion and Analysis
*For three months ended March 31, 2014*

Management's discussion and analysis ("MD&A") of the financial condition and the results of operations should be read in conjunction with the December 31, 2013 audited consolidated financial statements and the March 31, 2014 unaudited consolidated financial statements, together with the accompanying notes.

Additional information about Yangarra filed with Canadian securities commissions is available on-line at www.sedar.com.

The MD&A has been prepared using information that is current to May 13, 2014.

The financial information presented herein has been prepared on the basis of International Accounting Standard 34 ("Interim Financial Reporting"). Throughout this discussion, percentage changes are calculated using numbers rounded to the decimal to which they appear. All references to dollar amounts are in Canadian dollars.

**BOE Presentation –** Production information is commonly reported in units of barrel of oil equivalent ("boe"). For purposes of computing such units, natural gas is converted to equivalent barrels of oil using a conversion factor of six thousand cubic feet to one barrel of oil. This conversion ratio of 6:1 is based on an energy equivalent wellhead value for the individual products. Such disclosure of boe may be misleading, particularly if used in isolation. Readers should be aware that historical results are not necessarily indicative of future performance.

**Special Note Regarding Non-IFRS Measures** This MD&A contains the terms "funds flow from (used in) operations" and "funds flow from (used in) operations per share", which should not be considered an alternative to or more meaningful than cash from (used in) operating activities as determined in accordance with IFRS. These terms do not have any standardized meaning as prescribed by IFRS. Yangarra's determination of funds flow from (used in) operations and funds flow from (used in) operations per share may not be comparable to that reported by other companies. Management uses funds flow from (used in) operations to analyze operating performance and leverage, and considers funds flow from (used in) operations to be a key measure as it demonstrates the Company's ability to generate cash necessary to fund future capital investments and to repay debt, if applicable. Funds flow from (used in) operations is calculated using cash from (used in) operating activities as presented in the statement of cash flows before changes in non-cash working capital. Yangarra presents funds flow from (used in) operations per share whereby per share amounts are calculated using weighted average shares outstanding consistent with the calculation of earnings per share.

The following table reconciles funds flow from (used in) operations to cash from (used in) operating activities, which is the most directly comparable measure calculated in accordance with IFRS:

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Cash from operating activities | $ 6,008,779 | $ 10,757,178 | $ 4,452,879 |
| Changes in non-cash working capital | 4,450,913 | (2,781,590) | 361,304 |
| Funds flow from operations | $ 10,459,692 | $ 7,975,588 | $ 4,814,183 |

The Company considers corporate netbacks to be a key measure as they demonstrate Yangarra's profitability relative to current commodity prices. Corporate netbacks are comprised of operating, funds flow and net loss netbacks. Operating netback is calculated as the average sales price of its commodities (including realized gains on financial instruments) and then subtracts royalties, operating costs and transportation expenses. Funds flow netback starts with the operating netback and further deducts general and administrative costs, finance expense and adds finance income. To calculate the net income (loss) netback, Yangarra takes the funds flow netback and deducts share-based compensation expense as well as depletion and depreciation charges, accretion expense, unrealized gains on financial instruments, any impairment or exploration and evaluation expense and deferred income taxes. There is no IFRS measure that is reasonably comparable to netbacks.

Net debt and working capital (deficit), which represent current assets less current liabilities, excluding current derivative financial instruments, are used to assess efficiency, liquidity and the general financial strength of the Company. There is no IFRS measure that is reasonably comparable to net debt or working capital (deficit).

**Forward-looking Statements –** Certain information regarding the Company set forth in this report, including management's assessment of the Company's future plans and operations, contain forward-looking statements that involve substantial known and unknown risks and uncertainties. These risks and uncertainties, many of which are beyond the Company's control, include the impact of general economic conditions and specific industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers, the lack of available qualified personnel or management, stock market volatility and ability to access sufficient capital from internal and external sources. The Company's actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements, and accordingly, no assurance can be given that any events anticipated by the forward-looking statements will transpire or occur, or if any of them do, what benefits the Company can derive from such events.

## Overview

Yangarra is a junior oil and gas company engaged in the exploration, development and production of natural gas and oil with operations in Western Canada, with a main focus on Central Alberta, where the Company has extensive infrastructure and land holdings.

Yangarra is dedicated to creating value for its shareholders through its commitment to a clear business strategy and performance objectives. The Company's strategy is to increase the value of its corporate assets through the drill bit and by assembling a large focused land base in Central Alberta that features high-quality, long-life light oil and liquids-rich gas reserves. The Company has assembled a significant future drilling inventory and will strive to grow this inventory through drilling, geology and strategic acquisitions.

## First Quarter Highlights

During the three months ended March 31, 2014 the Company completed the following significant milestones:

- Production was 2,796 boe/d (53% oil and NGL's), a 55% increase from the same period in 2013.
- Oil and gas sales including royalty income were $16.0 million with funds flow from operations of $10.5 million ($0.07 per share - basic). This was a 132% and 119% increase from the same period in 2013, respectively.
- Earnings before interest, taxes, depletion & depreciation, amortization and changes in commodity contracts ("EBITDA") was $10.7 million, compared with $5.2 million in the same period of 2013.
- Operating costs, including $1.32 per boe of transportation costs, were $7.82 per boe, a reduction of 13% from the same period in 2013.
- Operating netback of $45.23 per boe, a 32% increase from the $34.34 per boe reported in the first quarter of 2013.
- G&A costs of $1.30 per boe, which is a 49% decrease from the first quarter of 2013.
- Royalties were 6% of oil and gas revenue.
- Total capital expenditures were $22.0 million.
- As at March 31, 2014, the Company had current bank debt, subordinated debt and working capital deficit, excluding fair value of commodity contracts and non-cash flow-through share premium obligations, of $55.8 million compared to $44.6 million at December 31, 2013.
    - The annualized first quarter debt to cash flow ratio was 1.3 : 1.

## Operations Update

The Company has successfully drilled or participated in 8 gross (6.2 net) wells during the first quarter of 2014. The Company experienced 11 days of shut-in production (approximately 1,200 boe/d for the 11 days) due to the TransCanada pipeline rupture near Rocky Mountain House and an additional 150 boe/d average for the quarter due to Keyera curtailments at other facilities. The Company drilled through break-up and expects to drill a total of 8 gross (5.1 net) wells in the second quarter.

# Financial Information

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| **Statements of Comprehensive Income (Loss)** | | | |
| Petroleum & natural gas sales and royalty income | $ 16,008,396 | $ 11,265,291 | $ 6,887,719 |
| Net income (loss) for the period (before tax) | $ 1,202,068 | $ 1,576,908 | $ (393,286) |
| Net income (loss) for the period | $ 719,450 | $ 750,851 | $ (259,424) |
| Net income (loss) per share - basic and diluted | $ 0.01 | $ 0.01 | $ (0.00) |
| **Statements of Cash Flow** | | | |
| Funds flow from (used in) operating activities | $ 10,459,692 | $ 7,975,588 | $ 4,814,183 |
| Funds flow from (used in) operating activities per share - basic and diluted | $ 0.07 | $ 0.06 | $ 0.04 |
| Cash from (used in) operating activities | $ 6,008,779 | $ 10,757,178 | $ 4,452,879 |
| **Statements of Financial Position** | | | |
| Property and equipment | $ 171,336,343 | $ 152,971,016 | $ 130,356,002 |
| Total assets | $ 195,777,835 | $ 169,798,021 | $ 148,761,517 |
| Working Capital (deficit), excluding MTM on commodity contracts and flow-through premium obligation | $ 55,822,090 | $ 36,794,243 | $ 42,469,266 |
| Non-Current Liabilities | $ 18,246,628 | $ 23,096,615 | $ 12,482,223 |
| Shareholders equity | $ 97,025,179 | $ 95,583,587 | $ 79,430,341 |
| Weighted average number of shares - basic | 147,410,341 | 127,219,336 | 121,711,723 |
| Weighted average number of shares diluted | 150,325,177 | 128,322,269 | 121,711,723 |

# Business Environment

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| **Realized Pricing (Including commodity contracts )** | | | |
| Oil ($/bbl) | $ 92.38 | $ 85.56 | $ 86.80 |
| NGL ($/bbl) | $ 53.32 | $ 52.08 | $ 52.62 |
| Gas ($/mcf) | $ 5.00 | $ 3.92 | $ 3.41 |
| **Realized Pricing (Excluding commodity contracts )** | | | |
| Oil ($/bbl) | $ 98.89 | $ 84.98 | $ 83.90 |
| NGL ($/bbl) | $ 68.74 | $ 51.45 | $ 48.30 |
| Gas ($/mcf) | $ 5.71 | $ 3.67 | $ 3.09 |
| **Oil Price Benchmarks** | | | |
| West Texas Intermediate ("WTI") (US$/bbl) | $ 98.70 | $ 97.46 | $ 94.36 |
| Edmonton (C$/bbl) | $ 90.70 | $ 86.58 | $ 87.43 |
| **Natural Gas Price Benchmarks** | | | |
| AECO gas (Cdn$/GJ) | $ 5.70 | $ 3.15 | $ 2.92 |
| **Foreign Exchange** | | | |
| U.S./Canadian Dollar Exchange | $ 0.910 | $ 0.953 | $ 0.992 |

Crude oil prices strengthened in the three months ended March 31, 2014, with the West Texas Intermediate ("WTI") reference price averaging US$97.70/bbl compared with US$94.36 per barrel the same period in 2013 and US$97.46/bbl in the fourth quarter of 2014. Demand for crude oil is generally tied to global economic growth, but is also influenced by factors such as infrastructure, political instability, market uncertainty, weather conditions and government regulations.

Edmonton par differentials to WTI widened in the three months ended March 31, 2014 when compared to the same period in 2013, moving from a $6.93/bbl differential in 2013 to $8.00/bbl in 2014. The Edmonton par differential to WTI was $10.88/bbl in the fourth quarter of 2013. The closest reference price point for Yangarra's oil is Edmonton par and therefore movements in the differential have a significant impact on the Company realized pricing.

When compared to the same period in 2013 realized pricing on oil increased by 18%, excluding commodity contracts and by 6% when the effects of commodity contracts are included. The increase in oil pricing is a direct result of the increased Edmonton par pricing.

When compared to the same period in 2013 liquids pricing increased by 42%, excluding commodity contracts and by 1% when the effects of commodity contracts are included. Significant improvements in propane prices were the largest factor in the improved liquids price.

During the three months ended March 31, 2014, Yangarra had contracted 1,200 bbl/day of oil production utilizing WTI fixed price contracts at an average price of $95.20 per bbl. Since the benchmark price was higher than our contracted value the realized prices were positively impacted. Since the product is intended to provide protection to both the oil and NGL revenue streams the commodity contracts impact is split between the two products.

AECO natural gas prices increased for the three months ended March 31, 2014 by 95% to $5.70/GJ from $2.92/GJ the same period in 2013. When compared to the fourth quarter of 2013 AECO increased by 81%.

Yangarra has contracted 5,000 GJ/day of 2014 natural gas production utilizing AECO fixed price contracts at an average price of $3.39 per GJ.

When compared to the same period in 2013 realized pricing on natural gas increased by 85%, excluding commodity contracts and by 47% when the effects of commodity contracts are included.

## Results of Operations

### Net petroleum and natural gas production, pricing and revenue

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| **Daily production volumes** | | | |
| Natural gas (mcf/d) | 7,572 | 8,303 | 5,090 |
| Oil (bbl/d) | 1,036 | 683 | 502 |
| NGL's (bbl/d) | 413 | 605 | 291 |
| Royalty income | | | |
| Natural gas (mcf/d) | 359 | 405 | 709 |
| Oil (bbl/d) | 0 | 1 | 2 |
| NGL's (bbl/d) | 25 | 24 | 48 |
| Combined (boe/d 6:1) | 2,796 | 2,764 | 1,809 |
| **Revenue** | | | |
| Petroleum & natural gas sales - Gross | $ 15,694,979 | $ 11,087,956 | $ 6,518,381 |
| Royalty income | 313,417 | 177,335 | 369,338 |
| Commodity contract settlement | (1,723,339) | 271,387 | 430,418 |
| Total sales | 14,285,057 | 11,536,678 | 7,318,137 |
| Royalty expense | (937,556) | (557,278) | (261,092) |
| Petroleum & natural gas sales - Net | 13,347,501 | 10,979,400 | 7,057,045 |
| Change in fair value of contracts | (4,403,102) | (2,217,286) | (2,185,484) |
| Total Revenue - Net of royalties | $ 8,944,399 | $ 8,762,114 | $ 4,871,561 |

Total sales in Q1 2014 were $14.3 million compared to $7.3 million in the same period 2013, the increase in sales is attributable to:

- a 30% increase in average product prices; and
- a 55 % increase in production (on a boe basis).

When compared to the $11.5 million of total sales in the fourth quarter of 2014, the increased sales are attributable to:

- a 24% increase in average product prices; and
- an 1 % increase in production (on a boe basis).

The increased production can be attributed to additional wells that were brought on production during 2014 and 2013. The Company drilled or participated in 8 gross (6.2 net) horizontal wells in the first quarter of 2014, combined with 15 gross (10.6 net) wells drilled and completed in 2013.

### Company Netbacks ($/boe)

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Sales Price | $ 62.37 | $ 43.61 | $ 40.03 |
| Royalty income | 1.25 | 0.70 | 2.27 |
| Royalty expense | (3.73) | (2.19) | (1.60) |
| Production costs | (6.49) | (6.20) | (8.04) |
| Transportation costs | (1.32) | (1.27) | (0.96) |
| **Field operating netback** | **52.07** | **34.63** | **31.70** |
| Commodity contract settlement | (6.85) | 1.07 | 2.64 |
| **Operating netback** | **45.23** | **35.70** | **34.34** |
| G&A and other (excludes non-cash items) | (1.30) | (2.07) | (2.54) |
| Finance expenses | (3.33) | (2.59) | (2.24) |
| **Cash flow netback** | **40.60** | **31.04** | **29.57** |
| Depletion and depreciation | (16.53) | (15.96) | (18.23) |
| Gain on sale of property and equipment | - | - | |
| Accretion | (0.16) | (0.16) | (0.33) |
| Stock-based compensation | (1.63) | - | - |
| Unrealized gain (loss) on financial instruments | (17.50) | (8.72) | (13.42) |
| Deferred income tax | (1.92) | (3.25) | 0.82 |
| **Net Income (loss) netback** | **$ 2.86** | **$ 2.95** | **$ (1.59)** |

The overall average price earned by the Company was higher when compared to 2013 due to higher natural gas and oil reference pricing and higher oil and liquids content in the product mix at 53% in 2014 versus 46% in 2013.

Operating netbacks increased by 32% when compared to the same period in 2013 and by 28% when compared to the fourth quarter of 2013 with improved realized pricing causing the majority of the increases.

### Royalty Income

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Royalty Income | $ 313,417 | $ 177,335 | $ 369,338 |

Royalty income decreased in 2014 to $313,417 when compared to the same period in 2013 as no new wells have been drilled on the royalty lands, leaving the existing royalty production subject to regular decline rates. The increase when compared to the fourth quarter of 2013 is due to increases in commodity prices. The majority of royalty income is a result of the 15% sliding scale royalty purchased in the Willesden Green area in March 2010. There are currently a total of 12 wells generating the 15% royalty income.

### Royalty Expense

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Royalty Expense | $ 937,556 | $ 557,278 | $ 261,092 |
| Per boe | $ 3.73 | $ 2.19 | $ 1.60 |
| As a % of sales | 6% | 5% | 4% |

Royalties increased to $937,556 for the three months ended March 31, 2014 or 6% as a percentage of sales. The increase results from wells coming off the new horizontal royalty program and higher commodity prices. Generally, royalty rates in Western Canada are sensitive to prevailing commodity prices, individual well depth and production rates. The crown royalty rate on the new horizontal wells in Central Alberta is 5% for the earlier of 2 years or 60,000 boe of production. Deep natural gas wells have a royalty rate of 5% for the first 5 years of production.

**Production and Transportation Costs**

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Production costs | $ 1,633,931 | $ 1,577,640 | $ 1,309,798 |
| Per boe | $ 6.49 | $ 6.20 | $ 8.04 |
| Transportation costs | $ 333,211 | $ 323,726 | $ 155,673 |
| Per boe | $ 1.32 | $ 1.27 | $ 0.96 |
| Combined ($/boe) | $ 7.82 | $ 7.48 | $ 9.00 |

Production and transportation costs increased in 2014 to $1,633,931 on a dollar basis due to additional production and decreased by 13% on a per boe basis when compared to the same period in 2013. When compared to the fourth quarter of 2013 the production costs remained relatively consistent.

As production volumes have increased the Company has implemented improvements to operating practices by hiring more experienced personal and streamlining operations across the Central Alberta area, this has allowed the Company to keep operating costs below $8.00/boe.

**Depletion, depreciation, impairment and accretion**

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Depletion and depreciation | $ 4,159,286 | $ 4,058,063 | $ 2,968,665 |
| Per boe | $ 16.53 | $ 15.96 | $ 18.23 |
| Accretion | $ 41,066 | $ 40,208 | $ 53,320 |

Depletion and depreciation increased in the first quarter 2014 compared to the same period 2013 due to increases in production. On a per boe basis the depletion remained relatively constant as the capital program resulted in equivalent additions to the reserve base.

**General and administrative expenses ("G&A")**

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Gross G&A expenses | $ 599,603 | $ 885,139 | $ 748,719 |
| G&A recoveries | (272,924) | (358,305) | (335,869) |
| Net G&A expenses | $ 326,679 | $ 526,834 | $ 412,850 |
| Per boe | $ 1.30 | $ 2.07 | $ 2.54 |

On a net basis, general and administrative expenses decreased by 21% in 2014 when compared to the same period in 2013 due to a decline in the total number of staff. On a per boe basis, G&A decreased by 49% when compared to the same period in 2013 due to higher production and a decline in the total number of staff. When compared to the fourth quarter of 2014 G&A was down 37% on a per boe basis as the fourth quarter numbers included the Company's annual bonus program.

### Other expenses

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Finance | | | |
| Interest | $ 593,988 | $ 575,612 | $ 364,541 |
| Change in fair value of interest rate contracts | 244,170 | 83,123 | - |
| Accretion | 41,066 | 40,208 | $ 53,320 |
| | $ 879,224 | $ 698,943 | $ 417,861 |
| Stock-based compensation | $ 410,000 | $ - | $ - |

Interest and financing fees for the three months ended March 31, 2014 include interest on the revolving operating demand loan (the average amount drawn in 2014 was $41 million) the subordinated term facility, renewal and servicing charges on the demand loan and the change in fair value of the interest rate contracts.

The Company had the following interest rate contracts in place at March 31, 2014:

- Pay a floating rate to receive a 2.35% (plus a 2.50% credit spread) fixed rate on $10 million (June 2014-June 2018)

- Pay a floating rate to receive a 2.15% (plus a 2.50% credit spread) fixed rate on $10 million (May 2014-May 2018)

The fair value on the interest rate contracts was in a loss position of $287,406 as at March 31, 2014 (2013 – $43,236).

During the three months ended March 31, 2014, the Company granted options to purchase 3,675,000 common shares, (1,000,000 of the options vested immediately and 2,675,000 of the options will vest equally over three years with the first tranche vesting one year after the grant date). The fair value of the options was estimated at $1,575,500 ($0.43 per option) using the Black-Scholes pricing model.

### Deferred Taxes

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Deferred income tax expense | $ 482,618 | $ 826,057 | $ (133,862) |

The Company's effective tax rate for 2014 was 25%, however, Yangarra did not pay income taxes in 2014 and does not expect to pay income taxes in 2015 as is has sufficient tax pools to cover taxable income.

### Commodity price risk contracts

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Realized gain on contract settlement | $ (1,723,339) | $ 271,387 | $ 430,418 |
| Change in fair value of commodity contracts | (4,403,102) | (2,217,286) | (2,185,484) |
| | $ (6,126,441) | $ (1,945,899) | $ (1,755,066) |

As at March 31, 2014, the Company was committed to the following commodity price risk contracts for the sale of oil:

2014 Contracts:

- 100 bbl/d from January 1 to December 31, 2014 at a fixed price of $98.30 CAD/bbl
- 100 bbl/d from January 1 to December 31, 2014 at a fixed price of $100.00 CAD/bbl
- 100 bbl/d from January 1 to December 31, 2014 at a fixed price of $91.40 CAD/bbl
- 100 bbl/d from January 1 to December 31, 2014 at a fixed price of $91.35 CAD/bbl
- 200 bbl/d from January 1 to December 31, 2014 at a fixed price of $92.00 USD/bbl
- 100 bbl/d from January 1 to December 31, 2014 at a fixed price of $90.00 USD/bbl
- 200 bbl/d from January 1 to December 31, 2014 at a fixed price of $93.52 CAD/bbl
- 100 bbl/d from January 1 to December 31, 2014 at a fixed price of $98.20 CAD/bbl
- 100 bbl/d from January 1 to June 30, 2014 at a fixed price of $100.00 CAD/bbl
- Sold Swaption on 100 bbl/d @ $100.00 WTI/CAD for July – December 2014

2015 Contracts:

- 100 bbl/d from January 1 to December 31, 2015 at a fixed price of $86.05 USD/bbl
- 100 bbl/d from January 1 to December 31, 2015 at a fixed price of $91.20 CDN/bbl
- 200 bbl/d from January 1 to December 31, 2015 at a fixed price of $90.37 CDN/bbl
- 200 bbl/d from January 1 to December 31, 2015 at a fixed price of $90.10 CDN/bbl
- 100 bbl/d from January 1 to December 31, 2015 at a fixed price of $92.25 CDN/bbl
- 200 bbl/d from January 1 to December 31, 2015 at a fixed price of $92.45 CDN/bbl

2016 Contracts:

- Sold Swaption on 200 bbl/d @ $95.00 WTI/USD for January – December 2016

As at December 31, 2013, the Company was committed to the following commodity price risk contracts on the AECO basis:

- 1,000 GJ/d at $3.11/GJ for Jan – Dec 2014
- 1,000 GJ/d at $3.05/GJ for Jan – Dec 2014
- 1,000 GJ/d at $3.54/GJ for Jan – Dec 2014
- 1,000 GJ/d at $3.54/GJ for Jan – Dec 2014
- 1,000 GJ/d at $3.73/GJ for Jan – Dec 2014

The fair value of the commodity contracts was in a loss position of $8,933,598 as at March 31, 2014 (2013 – $4,530,496).

The following table summarizes the sensitivity of the fair value of the Company's derivative positions as at March 31, 2014 to fluctuations in commodity prices, with all other variables held constant. When assessing the potential impact of these commodity price changes, the Company believes 10 percent volatility is a reasonable measure ($0.47/mcf for natural gas and $11/bbl for oil). Fluctuations in commodity prices potentially could have resulted in unrealized gains (losses) impacting income before tax as follows:

| Sensitivities | Impact on Income Before Tax | |
|---|---|---|
| | Increase 10% | Decrease 10% |
| Crude oil | (6,917,202) | 6,917,202 |
| Natural Gas | (649,000) | 649,000 |

## Liquidity and Capital Resources

The following table summarizes the change in working capital during the three months ended March 31, 2014 and the year ended December 31, 2013:

| | | 2014 | | 2013 |
|---|---|---|---|---|
| Working capital (deficit) - beginning of period (1) | $ | (36,794,243) | $ | (36,301,842) |
| Funds flow from operating activities | | 10,459,692 | | 25,648,666 |
| Additions to of property and equipment & E&E Assets | | (21,989,208) | | (47,485,106) |
| Issuance of shares | | 297,500 | | 13,593,273 |
| Issuance of Subordinated Debt | | 3,513 | | 7,786,632 |
| Other Debt | | (9,199) | | (35,866) |
| Working capital (deficit) - end of period (1) | $ | (48,031,945) | $ | (36,794,243) |
| Subordinated Debt Outstanding | $ | (7,790,145) | $ | (7,786,632) |
| Total Debt | $ | (55,822,090) | $ | (44,580,875) |
| Credit facility limit | $ | 45,000,000 | $ | 45,000,000 |
| Subordinated debt facility limit | $ | 20,000,000 | $ | 20,000,000 |

*(1) Excludes fair value of commodity contracts and non cash flow through share premium obligations*

As at March 31, 2014, the $43,659,054 (December 31, 2013 – $32,112,455) reported amount of bank debt with Alberta Treasury Branches ("ATB") was comprised of $6,550,000 (December 31, 2013 – $9,850,000) drawn on the revolving operating demand loan, $29,929,735 (December 31, 2013 – $19,963,177) of guaranteed notes and $7,179,319 (December 31, 2013 – $2,299,280) of outstanding cheques. The Company is subject to a financial covenant requiring an adjusted working capital ratio above 1 : 1 (current assets plus the undrawn availability under the revolving facility plus the undrawn availability under the subordinated term loan, divided by the current liabilities less the drawn portion of the revolving facility and the subordinated term loan, excluding unrealized commodity contracts and flow-through share premium liability). The facility is secured by a general security agreement.

As at March 31, 2014, the maximum amount available under the revolving operating demand loan was $45,000,000 (December 31, 2013 – $45,000,000) at an interest rate of bank prime plus 1.5% per annum on the operating demand loan, payable monthly, or a credit spread of 2.5% on guaranteed notes. The next scheduled review is May 31, 2014. A decrease in the borrowing base could result in a reduction to the credit facility, which may require repayment to the lenders. During the year, the weighted average effective interest rate for the bank debt was approximately 4.8% (2013 – 4.9%).

As at March 31, 2014 $7,800,000 was drawn on the $20,000,000 subordinated term loan facility with Alberta Treasury Branches ("ATB"). The subordinated term loan has a two year committed term (subject to an extension for an additional year upon mutual consent). There were two remaining tranches ($6,420,000 to be drawn on or before May 31, 2014 and $5,780,000 to be drawn on or before July 31, 2014) at an interest rate of bank prime plus 7.0% per annum, payable monthly, or a credit spread of 8.0% on guaranteed notes. Full payment of the principal is due on September 3, 2015.

The Company is subject to financial covenants on the subordinated term facility requiring an adjusted working capital ratio greater than 1 : 1 (calculation consistent with the calculation disclosed above) and a Debt to EBITDA ratio below 4 : 1 (debt is defined as all obligations, liabilities and indebtedness on the balance sheet and EBITDA is defined as earnings plus interest expense and other financing costs, depletion and depreciation and income taxes). In addition the Company is required to comply with a PV10 proved developed producing to debt ratio of not less than 0.92 : 1 on specified dates and a PV10 total proved to debt ratio of not less than 1.5 : 1 on specified dates. This facility is secured with a pledge of a general demand debenture and a general security agreement. During the quarter, the weighted average effective interest rate for the subordinated debt was approximately 9.22% (2013 – nil).

Subsequent to March 31, 2014, the Company entered into an amended and restated credit facility agreement which increases its operating demand loan to $70 million from the existing $45 million. Also subsequent to March 31, 2014, the Company entered into an amended and restated subordinated facility agreement resulting in the $20 million subordinated debt facility with ATB remaining in place. The $7.8 million previously drawn on the subordinated debt will be repaid with the increased operating demand loan. As a result, the subordinated term facility was classified as a current liability as at March 31, 2014.

The Company is in compliance with all covenants as at March 31, 2014.

The annualized first quarter cash flow ratio as at March 31, 2014 was 1.3 : 1. All ratios include the subordinated debt but exclude the fair value of commodity contracts and the flow through share obligations.

Yangarra intends to fund the 2014 budget (which includes the $4.9 million of CEE commitments) with cash flow from operations and the increased availability on the revolving operating demand loan, the subordinated term loan and the recently announced equity financing.

## Capital Spending

Capital spending is summarized as follows:

| | 2014 | 2013 | |
|---|---|---|---|
| Cash Additions | Q1 | Q4 | Q1 |
| Land, acquistions and lease rentals | $ 972,133 | $ (261,263) | $ 1,060,280 |
| Drilling and completion | 18,373,739 | 18,958,090 | 8,036,865 |
| Geological and geophysical | 320,227 | 170,565 | 33,678 |
| Equipment | 2,324,948 | 1,490,863 | 1,879,815 |
| Other Asset Additions | (1,839) | 100,771 | 251,954 |
| | $ 21,989,208 | $ 20,459,026 | $ 11,262,592 |
| Exploration & evaluation assets additions | $ - | $ 2,461,506 | $ - |

The Company drilled 8 gross (6.2 net) horizontal wells during the three months ended March 31, 2014. The drilling resulted in increased production.

In 2014, the average drill cost per well was $1.7 million and the average completion cost per well was $1.0 million, with the remainder of the drilling and completion costs from coming prior period items and work-overs.

## Outlook

The $75 million 2014 capital budget is focused on the development of Yangarra's Central Alberta play with 28 gross (22.7 net) wells planned for the year. The budget also includes a Duvernay strata-graphic vertical test well.

The budget is expected to result in annual production of 3,500 boe/d which represents a 59% increase from 2013. Funds flow from operations is expected to be $50 million which is a 95% increase from 2013. The Company expects year-end 2014 total net debt of $45 million resulting in a debt to annual cash flow ratio of 0.9 to 1.0. The budget assumes an average price of US$95.00/bbl for WTI crude oil (CDN$85.00/bbl Edmonton par) and an average price of $3.50/GJ for AECO natural gas.

## Decommissioning Liabilities

As at March 31, 2014, the undiscounted decommissioning obligation associated with the Company's existing properties was estimated to be $8,689,186 for which $6,059,051 has been recorded using a discount rate of 2.03% - 2.96%, an inflation rate of 2% and an estimated weighted average timing of cash flows of 15 years.

## Off Balance Sheet Arrangements

There were no off balance sheet arrangements, other than the office and truck lease commitment which is accounted for as an operating lease.

## Related Party Transactions

During the three months ended March 31, 2014 and 2013 the Company was charged or invoiced the following amounts by certain of its officers and directors through controlled companies:

| | 2014 | 2013 | |
|---|---|---|---|
| | Q1 | Q4 | Q1 |
| Administration and consulting fees | $ 99,000 | $ 318,008 | $ 50,602 |
| Production and capital expenditures | 6,250 | 27,071 | 87,286 |
| | $ 105,250 | $ 345,078 | $ 137,888 |

Included in accounts payable and accrued liabilities at March 31, 2014 is $8,472 (December 31, 2013 – $7,727) relating to the above transactions. These transactions were in the normal course of operations and were measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

Other long-term liabilities include a mortgage for $319,346 (December 31, 2013 - $328,545) held in the name of an officer of the Company for a property that is used as a field office. The Company is the beneficial owner through a trust agreement of the property against which the mortgage is secured. All mortgage payments are made by the Company.

## Share Capital

Details of changes in the number of outstanding equity instruments are detailed in the following table:

| | Common Shares | Warrants | Stock Options |
|---|---|---|---|
| **Balance - December 31, 2013** | 147,117,008 | 1,420,000 | 10,635,000 |
| Equity Financing | - | - | - |
| Grant of options | - | - | 3,675,000 |
| Forfeiture of options | - | - | - |
| Exercise of options | 825,000 | - | (825,000) |
| Expiry of options | - | - | - |
| **Balance - March 31, 2014** | 147,942,008 | 1,420,000 | 13,485,000 |
| Grant of Options | - | - | 200,000 |
| Exercise of options | - | - | - |
| **Balance - Date of MD&A** | 147,942,008 | 1,420,000 | 13,685,000 |

## Contingency

In December 2009, the Company terminated the Standstill Agreement that it had with an industry partner regarding a joint producing property and served that industry partner with a Statement of Claim issued from The Court of Queen's Bench of Alberta, by which the Company claims breach of the agreements between the parties, gross negligence and default of operator. The Company seeks judgment for specified and such further damages to be determined by the Court, as well as appointment as operator. The Company increased the statement of claim based on the information provided by the defendant. The potential outcome of the lawsuit and claims are undetermined, however, they could be material.

In the normal conduct of operations, there are other pending claims by and against the Company. Litigation is subject to many uncertainties, and the outcome of individual matters is not predictable with assurance. In the opinion of management, based on the advice and information provided by its legal counsel, the final determination of these other litigations will not materially affect the Company's financial position or results of operations

## Commitments

The Company has until December 31, 2014 to incur $4.9 million of qualifying CEE flow-through expenditures related to CEE flow-through shares issued in December 2013.

The Company has entered into lease agreements for office premises, field equipment and Company vehicles with estimated minimum annual payments as follows:

| | | |
|---|---|---|
| 2014 | $ | 180,958 |
| 2015 | $ | 241,277 |
| 2016 | $ | 241,277 |

## Financial Instruments and Financial Risk Management

The Company's financial instruments include accounts receivable, bank debt, subordinated debt, accounts payable and accrued liabilities, other long term liabilities, interest rate contracts and commodity contracts. The carrying values of accounts receivable, accounts payable and accrued liabilities, other long term liabilities and bank debt approximate their fair values due to their relatively short periods to maturity. The fair value of the subordinated debt is approximately equal to the carrying value as the debt is subject to a floating interest rate.

The Company is required to classify fair value measurements using a hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy is as follows:

- Level 1 - quoted prices in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 - inputs for the asset or liability that are not based on observable market data.

The fair value of the interest rate contracts and the commodity contracts is classified as level 2. The fair value is calculated using the forward price curves as at March 31, 2014.

The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities. The Company has exposure to credit risk, liquidity risk and market risk as a result of its use of financial instruments. This note presents information about the Company's exposure to each of the above risks and the Company's objectives, policies and processes for measuring and managing these risks. Further quantitative disclosures are included throughout these financial statements. The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with the risk management policies as set out herein:

### a. Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. A substantial portion of the Company's accounts receivable are with natural gas and liquids marketers and joint venture partners in the oil and gas industry and are subject to normal industry credit risks.

Purchasers of the Company's natural gas and liquids are subject to credit review to minimize the risk of non-payment. As at March 31, 2014, the maximum credit exposure is the carrying amount of the accounts receivable of $16,446,307 (December 31, 2013 – $8,846,547).

The maximum exposure to credit risk for receivables at the reporting date by type of customer was:

| | | |
|---|---|---|
| Oil and natural gas marketers | $ | 5,164,739 |
| Joint venture partners | | 2,691,529 |
| Other | | 8,590,039 |
| | $ | 16,446,307 |

Receivables from petroleum and natural gas marketers are typically collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any significant collection issues with its petroleum and natural gas marketers. All of the revenue accruals and receivables from petroleum and natural gas marketers were received in April 2014.

Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company mitigates the risk from joint venture receivables by obtaining partner approval of capital expenditures prior to starting a project. However, the receivables are from participants in the petroleum and natural gas sector, and collection is dependent on typical industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. Further risk exists with joint venture partners as disagreements occasionally arise which increases the potential for non-collection. For properties that are operated by the Company, production can be withheld from joint venture partners who are in default of amounts owing. In addition, the Company often has offsetting amounts payable to joint venture partners from which it can net receivable balances.

The Company did not provide for any doubtful accounts nor was it required to write-off any accounts receivable during the three months ended March 31, 2014.

As at March 31, 2014, the Company considers its receivables to be aged as follows:

| | | |
|---|---|---|
| Not past due | $ | 10,416,110 |
| Past due by less than 90 days | | 595,316 |
| Past due by more than 90 days | | 5,434,881 |
| | $ | 16,446,307 |

### b. Liquidity risk

Liquidity risk is the risk that the Company will incur difficulties meeting its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation. The

Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. The Company uses authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures.

To facilitate the capital expenditure program, the Company has a credit facility agreement which is regularly reviewed by the lender. The Company monitors its total debt position monthly. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month. The Company anticipates it will have adequate liquidity to fund its financial liabilities through its future cash flows. The Company's financial liabilities are comprised of accounts payable and accrued liabilities, commodity contracts, interest rate contracts, bank debt and subordinated debt, which are classified as current or non-current on the balance based on their maturity dates.

Yangarra intends to fund the 2014 budget (which includes the $4.9 million of CEE commitments) with cash flow from operations and the increased availability on the revolving operating demand loan, the subordinated term loan and the recently announced equity financing.

**c. Market risk**

Market risk consists of interest rate risk, currency risk and commodity price risk. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Company may use both financial derivatives and physical delivery sales contracts to manage market risks. All such transactions are conducted in accordance with a risk management policy as set out herein:

i. Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its bank debt which bears interest at a floating rate and to mitigate this risk, the Company has entered into interest rate contracts. For the three months ended March 31, 2014, if interest rates had been 1% lower with all other variables held constant, income for the period would have been $588,851 (March 31, 2013 - $421,205) higher, due to lower interest expense. An equal and opposite impact would have occurred had interest rates been higher by the same amount.

ii. Currency risk

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange rates. All of the Company's petroleum and natural gas sales are denominated in Canadian dollars, however, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. The Company had no outstanding forward exchange rate contracts in place at March 31, 2014.

iii. Commodity price risk

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand as well as the relationship between the Canadian and United States dollar, as outlined above.

## Capital disclosures

The Company's objective when managing capital is to maintain a flexible capital structure which will allow it to execute its capital expenditure program, which includes expenditures in oil and gas activities which may or may not be successful. Therefore, the Company monitors the level of risk incurred in its capital expenditures to balance the proportion of debt and equity in its capital structure.

The Company considers its capital structure to include shareholders equity and debt:

| | *March 31, 2014* | *December 31, 2013* |
|---|---|---|
| Shareholders' equity | $ 97,025,179 | $ 95,583,587 |
| Bank debt | $ 43,659,056 | $ 32,112,455 |
| Subordinated debt | $ 7,790,145 | $ 7,786,632 |

The Company monitors capital based on annual cash from operations before changes in non-cash working capital and capital expenditure budgets, which are updated as necessary and are reviewed and periodically approved by the Board of Directors.

The Company manages its capital structure and makes adjustments by continually monitoring its business conditions including the current economic conditions, the risk characteristics of the Company's petroleum and natural gas assets, the depth of its investment opportunities, current and forecasted net debt levels, current and forecasted commodity prices and other facts that influence commodity prices and funds from operations such as quality and basis differentials, royalties, operating costs and transportation costs.

In order to maintain or adjust the capital structure, the Company considers its forecasted cash from operations before changes in non-cash working capital while attempting to finance an acceptable capital expenditure program including acquisition opportunities, the current level of bank credit available from the Company's lender, the level of bank credit that may be attainable from its lender as a result of petroleum and natural gas reserve growth, the availability of other sources of debt with different characteristics than existing debt, the sale of assets, limiting the size of the capital expenditure program and the issue of new equity if available on favorable terms. At March 31, 2014, the Company's capital structure was not subject to external restrictions. No changes have been made to the capital policy since 2013.

## Selected Historical Financial Information

| | **2014 Q1($)** | 2013 Q4($) | 2013 Q3($) | 2013 Q2($) |
|---|---|---|---|---|
| Petroleum & natural gas sales and royalty income | **16,008,396** | 11,265,291 | 9,568,399 | 8,113,998 |
| Net petroleum and natural gas revenue | **15,070,840** | 10,708,013 | 8,866,802 | 7,837,133 |
| Net income (loss) | **719,450** | 750,851 | 11,330 | 2,082,942 |
| Net income (loss) per share – basic | **0.01** | 0.01 | 0.00 | 0.02 |
| Net income (loss) per share – diluted | **0.01** | 0.01 | 0.00 | 0.02 |
| Funds flow from operations | **10,459,692** | 7,975,588 | 6,378,207 | 6,480,689 |
| Funds flow from operations per share – basic | **0.07** | 0.06 | 0.05 | 0.05 |
| Funds flow from operations per share –diluted | **0.07** | 0.06 | 0.05 | 0.05 |
| Net capital expenditures | **21,989,208** | 22,920,532 | 8,567,226 | 3,708,601 |

| | 2013 Q1($) | 2012 Q4($) | 2012 Q3($) | 2012 Q2($) |
|---|---|---|---|---|
| Petroleum & natural gas sales and royalty income | 6,887,719 | 5,059,036 | 4,635,685 | 5,910,666 |
| Net petroleum and natural gas revenue | 6,626,627 | 5,055,666 | 4,311,406 | 5,627,535 |
| Net loss | (259,424) | 340,623 | (2,073,174) | 3,305,628 |
| Net loss per share – basic | 0.00 | 0.00 | (0.02) | 0.03 |
| Net loss per share – diluted | 0.00 | 0.00 | (0.02) | 0.03 |
| Funds flow from operations | 4,814,183 | 3,168,328 | 2,780,520 | 3,493,003 |
| Funds flow from operations per share – basic | 0.04 | 0.03 | 0.02 | 0.03 |
| Funds flow from operations per share –diluted | 0.04 | 0.03 | 0.02 | 0.03 |
| Net capital expenditures | 11,262,592 | 4,537,364 | 4,679,623 | 3,006,024 |

Fluctuations in quarterly revenues net income and funds flow from operations over the last eight quarters are due primarily to the volatility in commodity prices and changes in sales volumes due to production growth through successful drilling activity.

## Business Risks and Uncertainties

Refer to the December 31, 2013 MD&A for a complete listing of Business Risks and Uncertainties.

## Environmental Risks

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of federal, provincial and local laws and regulations. Compliance with such legislation can require significant expenditures and a breach could result in the imposition of fines and penalties, some of which could be material. Senior management continually assesses new and existing regulatory requirements and environmental risks and determines the impact these risks might have on the Company, as well as the appropriate actions necessary to manage those risks. These assessments and the resulting policy decisions are discussed quarterly with the Board of Directors which evaluates the performance and effectiveness of the Company's environmental policies and programs.

The Company's environmental responsibilities includes removing property, plant and equipment as well as reclaiming land and property to its original state, subsequent to the completion of oil and natural gas extraction activities. This requirement results in an asset retirement obligation that provides current recognition of estimated expenditures that will be incurred in the future. The Company's decommissioning liabilities are discussed in further detail under "Critical Accounting Estimates" below, as well as in note 6 to the Company's Consolidated Financial Statements.

## Disclosure Controls and Procedures

The Company's certifying officers will file a Venture Issuer Basic Certificate with respect to the information contained in its financial statements and accompanying Management's Discussion and Analysis. The Venture Issuer Basic Certification includes a 'Notice to Reader' stating that the certifying officers do not make any representations relating to the establishment and maintenance of disclosure controls and procedures and internal control over financial reporting, as defined in National Instrument 52-109 – Certification of Disclosure in Issuers' Annual and Interim Filings.

## Critical Accounting Estimates

Refer to the December 31, 2013 MD&A for a complete listing of critical accounting estimates.

## Accounting standards newly adopted

On January 1, 2014 the Company adopted the following new standards:

The IASB issued International Financial Reporting Interpretations Committee Interpretation ("IFRIC") 21, "Levies". The IFRIC clarifies that an entity should recognize a liability for a levy when the activity that triggers payment occurs. The adoption of this interpretation had no significant impact on the Company's consolidated financial statements.

IAS 32, "Financial Instruments: Presentation", which clarifies the requirements for offsetting financial assets and liabilities. The amendments clarify when an entity has a legally enforceable right to offset and certain other requirements that are necessary to present a net financial asset or liability. There was no impact to the Company on adoption of this standard.