# Q3 2015

PHX
ENERGY SERVICES CORP.

# PHX Energy Services Corp.

## Third Quarter Report for the three and nine-month periods ended September 30, 2015 and 2014

## Financial Results

In the three-month period ended September 30, 2015 adjusted EBITDA was $8.9 million (13 percent of revenue), which is 66 percent lower than the $25.9 million (19 percent of revenue) reported in the comparable 2014-period. Adjusted EBITDA is defined as earnings before finance expense, income taxes, depreciation and amortization ("EBITDA"), loss on disposition of drilling equipment, impairment losses on goodwill and intangible assets, provisions for the settlement of litigations, and severance costs (see Non-GAAP measures section). This decrease was primarily due to weak activity levels and lower average day rates realized in the 2015-quarter. However, relative to the first quarter of 2015 when adjusted EBITDA was 7 percent of revenue, profitability has significantly improved as adjusted EBITDA represented 13 percent of revenue in the third quarter of 2015. These positive results were primarily driven by the various initiatives that were implemented by Management to align the Corporation's cost structure with contracted activity levels.

For the three-month period ended September 30, 2015, PHX Energy generated consolidated revenue of $68.2 million, 51 percent lower than the $139.0 million generated in the 2014-period. This decrease is mainly due to lower industry activity and pricing pressures in all of the Corporation's operating segments. In the three-month period ended September 30, 2015, PHX Energy reported a net loss of $24.5 million compared to net earnings of $13.0 million in the third quarter of 2014. The net loss incurred during the 2015-quarter was mainly due to the recognition of the following charges (pre-tax): a provision of $5.6 million relating to the settlement of litigations in the US, a $13.8 million impairment loss on the goodwill and intangible assets related to the Corporation's Stream Services ("Stream") cash-generating unit ("CGU"), a $4.3 million loss on the disposition of equipment primarily due to decommissioned assets, and $4.8 million of additional depreciation and amortization expenses that resulted from a change in the Corporation's estimate of the residual values of its drilling equipment.

As at September 30, 2015, PHX Energy had long-term debt of $70.0 million and working capital of $59.8 million.

## Provisions

In September, 2015, the Corporation's wholly-owned subsidiary, Phoenix Technology Services USA Inc. ("Phoenix USA") and the parties to the collective and class actions in the US entered into a settlement agreement wherein the parties have agreed for the full and final release and dismissal of all claims and allegations made in the collective and class actions, by the establishment of a US$5.0 million (equivalent to CDN$6.5 million) settlement fund. As a result, an additional $5.6 million was recognized as provision for the settlement of litigations in the three-month period ended September 30, 2015.

## Goodwill and Intangible Asset Impairment

In the third quarter of 2015, the Corporation recognized an impairment loss of $13.8 million related to its Stream CGU. Of the impairment loss, $7.3 was allocated to goodwill and $6.5 million was allocated to intangible assets, which are comprised of $5.8 million relating to an old version of the electronic drilling recorder ("EDR") technology and $0.7 million relating to a customer relationship.

## Change in Estimate

In September, 2015, the Corporation reviewed the residual values of its drilling equipment and now expects it to be nil instead of its previous estimate of zero to 20 percent of acquisition cost. The effect of this change was an increase of $4.8 million in the depreciation expense for the 2015-quarter.

## Severance

As a result of Management's continued efforts to align the Corporation's cost structure with the lower activity levels, severance payments of $1.3 million and $5.4 million, included in direct costs and SG&A, were incurred in the three and nine-month periods ended September 30, 2015, respectively.

## Capital Spending

To preserve cash flows, the Corporation was cautious with its capital spending. For the three-month period ended September 30, 2015, only $2.3 million in capital expenditures were incurred, which is 93 percent less than the $31.2 million incurred in the comparable 2014-period. At the end of September, 2015, an additional $0.8 million of equipment is on order, which is expected to be received within the next quarter. It is expected that $18.5 million in capital expenditures will be spent in the 2015-year.

## Amendments to Credit Facilities

On October 16, 2015, the Corporation amended its credit agreement with its syndicate of lenders. The key amendments reflected the following revisions to PHX Energy's financial and negative covenants under its credit facilities (defined terms have the meanings ascribed thereto in the credit agreement, a copy of which can be found under PHX Energy's profile on SEDAR at www.sedar.com):

- The ratio of debt to covenant EBITDA shall not exceed 5.0x for the quarters ending December 31, 2015, March 31, 2016, June 30, 2016 and September 30, 2016, shall not exceed 4.0x for the quarter ending December 31, 2016 and shall not exceed 3.0x for the quarter ending March 31, 2017, all calculated on a four quarter rolling basis.

- For the purposes of the calculation of the covenant EBITDA during the period from the quarter ended March 31, 2015 to the quarter ending March 31, 2016, PHX Energy shall be permitted to add back actual severance costs paid up to a maximum of CDN$5.0 million and settlement amounts to be paid (and provisions made in respect thereof) by the Corporation in respect of the US litigations to a maximum aggregate of CDN$6.5 million.

- The Corporation's negative covenant, which limits its annual dividends based on the amount of its yearly distributable cash flow, shall not apply to the financial year ending December 31, 2015. In addition, during the covenant relief period through to December 31, 2016, there will be no increases permitted in the rate of dividends payable by the Corporation.

- The maximum principal amounts available to the Corporation under each of the Syndicated Credit Facility and the U.S. Operating Facility were reduced from CDN$160 million to CDN$90 million and US$25 million to US$2.5 million, respectively. The purpose of the decrease is to reduce the standby fees charged on unused balances under the credit facilities.

## Dividends

During the third quarter of 2015, the Corporation paid dividends of $2.2 million or $0.05 per share. As previously announced, the Board of Directors (the "Board") approved a reduction to PHX Energy's monthly dividend from $0.0175 per share per month to $0.0033 per share per month effective for the September dividend. Following payment of the September dividend, the Corporation has transitioned to a quarterly dividend payment structure.

PHX Energy announces that the Board has declared a quarterly dividend of $0.01 per share effective for the fourth quarter of 2015, payable on January 15, 2016 to shareholders of record at the close of business on December 31, 2015. The ex-dividend date is December 29, 2015. The dividend is designated as an "eligible dividend" within the meaning of subsection 89(1) of the *Income Tax Act* (Canada).

*(Stated in thousands of dollars except per share amounts, percentages and shares outstanding)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| **Operating Results** | ***(unaudited)*** | *(unaudited)* | | ***(unaudited)*** | *(unaudited)* | |
| Revenue | **68,227** | 138,971 | (51) | **230,642** | 368,586 | (37) |
| Net earnings (loss) | **(24,515)** | 13,024 | n.m. | **(38,707)** | 20,775 | n.m. |
| Earnings (Loss) per share – diluted | **(0.59)** | 0.37 | n.m. | **(1.03)** | 0.59 | n.m. |
| Adjusted EBITDA [1] | **8,906** | 25,889 | (66) | **17,058** | 53,197 | (68) |
| Adjusted EBITDA per share – diluted [1] | **0.21** | 0.73 | (71) | **0.46** | 1.52 | (70) |
| Adjusted EBITDA as a percentage of revenue [1] | **13%** | 19% | | **7%** | 14% | |
| **Cash Flow** | | | | | | |
| Cash flows from operating activities | **10,780** | (1,735) | n.m. | **42,950** | 17,664 | 143 |
| Funds from operations [1] | **677** | 26,702 | (97) | **4,317** | 53,720 | (92) |
| Funds from operations per share – diluted [1] | **0.02** | 0.75 | (97) | **0.12** | 1.53 | (92) |
| Dividends paid | **2,181** | 7,356 | (70) | **12,681** | 21,808 | (42) |
| Dividends per share [2] | **0.05** | 0.21 | (76) | **0.35** | 0.63 | (44) |
| Capital expenditures | **2,338** | 31,236 | (93) | **17,156** | 55,761 | (69) |
| | | | | | | |
| **Financial Position (unaudited)** | | | | **Sep 30, '15** | Dec 31, '14 | |
| Working capital | | | | **59,809** | 80,974 | (26) |
| Long-term debt | | | | **70,000** | 104,281 | (33) |
| Shareholders' equity | | | | **202,086** | 199,961 | 1 |
| Common shares outstanding | | | | **41,565,727** | 35,237,839 | 18 |

n.m. – not meaningful

[1] Refer to non-GAAP measures section.

[2] Dividends paid by the Corporation on a per share basis in the period.

# Non-GAAP Measures

PHX Energy uses certain performance measures throughout this Management's Discussion and Analysis ("MD&A") that are not recognizable under Canadian generally accepted accounting principles ("GAAP"). These performance measures include adjusted EBITDA, adjusted EBITDA per share, funds from operations, funds from operations per share and debt to covenant EBITDA ratio. Management believes that these measures provide supplemental financial information that is useful in the evaluation of the Corporation's operations and are commonly used by other oil and natural gas service companies. Investors should be cautioned, however, that these measures should not be construed as alternatives to measures determined in accordance with GAAP as an indicator of PHX Energy's performance. The Corporation's method of calculating these measures may differ from that of other organizations, and accordingly, these may not be comparable. Please refer to the non-GAAP measures section.

# Management's Discussion and Analysis

The following MD&A of the financial condition, results of operations, and cash flow of PHX Energy Services Corp. ("PHX Energy" or the "Corporation") should be read in conjunction with the Corporation's 2014 annual report, including the MD&A, and audited consolidated financial statements and the accompanying notes contained therein, and the Corporation's 2015 unaudited interim third quarter report, including the unaudited condensed consolidated financial statements and the accompanying notes contained therein. Readers can also obtain additional information on the Corporation including its Information Circular and Annual Information Form ("AIF") filed on SEDAR at www.sedar.com. This MD&A has been prepared taking into consideration information available up to and including November 4, 2015.

PHX Energy's Interim Financial Report for the three and nine-month periods ended September 30, 2015 and 2014 has been prepared in accordance with International Financial Reporting Standards ("IFRS"). The MD&A and Interim Financial Report were reviewed by PHX Energy's Audit Committee and approved by PHX Energy's Board on November 4, 2015.

## Definitions

When the Corporation refers to operating days throughout this document, it is referring to the billable days on which PHX Energy is providing services to the client at the rig site. Average Operating Day Rate is calculated by dividing revenue by the number of operating days.

# Cautionary Statement Regarding Forward-Looking Information and Statements

This MD&A contains certain forward-looking information and statements within the meaning of applicable securities laws. The use of "expect", "anticipate", "continue", "estimate", "objective", "ongoing", "may", "will", "project", "could", "should", "can", "believe", "plans", "intends", "strategy" and similar expressions are intended to identify forward-looking information or statements.

The forward-looking information and statements included in this MD&A are not guarantees of future performance and should not be unduly relied upon. These statements and information involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements and information. The Corporation believes the expectations reflected in such forward-looking statements and information are reasonable, but no assurance can be given that these expectations will prove to be correct. Such forward-looking statements and information included in this MD&A should not be unduly relied upon. These forward-looking statements and information speak only as of the date of this MD&A.

In particular, forward-looking information and statements contained in this MD&A include, without limitation:

- At the end of September, 2015, an additional $0.8 million of equipment is on order, which is expected to be received within the next quarter.
- It is expected that $18.5 million in capital expenditures will be spent in the 2015-year.
- Engineering efforts and field testing continue on advanced features of Velocity, including unified telemetry, that are expected to be commercial in 2016.
- The Corporation's ability to maintain the current level of dividends to its shareholders is dependent upon the realization of cash flow from operations, and if the Corporation does not meet its budgeted cash flow from operations, dividends to shareholders may be reduced.
- Planned capital expenditures are expected to be financed from a combination of one or more of the following: cash flow from operations, the Corporation's unused credit facilities or equity, if necessary

The above are stated under the headings: "Financial Highlight", "About PHX Energy Services Corp.", "Liquidity", and "Capital Resources",. Furthermore, all information contained within the Outlook section of this report contains forward-looking statements.

In addition to other material factors, expectations and assumptions which may be identified in this MD&A and other continuous disclosure documents of the Corporation referenced herein, assumptions have been made in respect of such forward-looking statements and information regarding, among other things: the Corporation will continue to conduct its operations in a manner consistent with past operations; the general continuance of current industry conditions; anticipated financial performance, business prospects, impact of competition, strategies, the general stability of the economic and political environment in which the Corporation operates; exchange and interest rates; tax laws; the sufficiency of budgeted capital expenditures in carrying out planned activities; the availability and cost of labour and services and the adequacy of cash flow; debt and ability to obtain financing on acceptable terms to fund its planned expenditures, which are subject to change based on commodity prices; market conditions and future oil and natural gas prices; and potential timing delays. Although Management considers these material factors, expectations and assumptions to be reasonable based on information currently available to it, no assurance can be given that they will prove to be correct.

Readers are cautioned that the foregoing lists of factors are not exhaustive. Additional information on these and other factors that could affect the Corporation's operations and financial results are included in reports on file with the Canadian Securities Regulatory Authorities and may be accessed through the SEDAR website (www.sedar.com) or at the Corporation's website. The forward-looking statements and information contained in this MD&A are expressly qualified by this cautionary statement. The Corporation does not undertake any obligation to publicly update or revise any forward-looking statements or information, whether as a result of new information, future events or otherwise, except as may be required by applicable securities laws.

# About PHX Energy Services Corp.

The Corporation, through its directional drilling subsidiary entities, provides horizontal and directional drilling technology and services to oil and natural gas producing companies in Canada, the US, Albania, and Russia. PHX Energy also provides electronic drilling recorder ("EDR") technology and services.

PHX Energy's Canadian directional drilling operations are conducted through Phoenix Technology Services LP. The Corporation maintains its corporate head office, research and development, Canadian sales, service and operational centres in Calgary, Alberta. In addition, PHX Energy has a facility in Estevan, Saskatchewan. PHX Energy's US operations, conducted through the Corporation's wholly-owned subsidiary, Phoenix Technology Services USA Inc. ("Phoenix USA"), is headquartered in Houston, Texas. Phoenix USA has sales and service facilities in Houston, Texas; Denver, Colorado; Fort Worth, Texas; Midland, Texas; Bellaire, Ohio; Pittsburgh, Pennsylvania; and Oklahoma City, Oklahoma. Internationally, PHX Energy has sales offices and service facilities in Albania and Russia, and administrative offices in Nicosia, Cyprus and Luxembourg City, Luxembourg.

PHX Energy markets its EDR technology and services in Canada through its division, Stream Services, which has an office and operations center in Calgary, Alberta. EDR technology is marketed worldwide outside Canada through its wholly-owned subsidiary Stream Services International Inc.

PHX Energy, in collaboration with leading edge engineering companies in North America, is in the process of developing new technologies. One of these technologies is the Velocity Real-Time System ("Velocity"). Velocity is a new generation MWD platform that offers unique drilling capabilities to the land market which dramatically reduce risks of non-productive time and enhance drilling performance with highly sophisticated measurements. Having been rigorously tested in some of North America's most challenging drilling environments, in July 2015, PHX Energy began actively marketing Velocity as an EM platform. Engineering efforts and field testing continue on advanced features, including unified telemetry, that are expected to be commercial in 2016. Currently PHX Energy has a fleet of 40 Velocity systems.

# Results of Operations

Three and Nine-Month Periods Ended September 30, 2015

## Revenue

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| Revenue | **68,227** | 138,971 | (51) | **230,642** | 368,586 | (37) |

Industry activity in all of the Corporation's operating segments remained weak and pricing pressures continued to mount as depressed oil prices carried through the third quarter of 2015. For the three-month period ended September 30, 2015, consolidated revenue decreased by 51 percent to $68.2 million compared to $139.0 million in the comparable 2014-period. US and international revenue as a percentage of total consolidated revenue were 62 and 9 percent, respectively, for the 2015-quarter as compared to 55 and 9 percent in 2014. Consolidated operating days decreased by 49 percent to 5,387 days as compared to 10,462 days in the 2014-quarter. Average consolidated day rates for the three-month period ended September 30, 2015, excluding the motor rental division in the US and the Stream division, decreased by 3 percent to $12,269 from $12,701 in the third quarter of 2014. Excluding the impact of US foreign exchange, average consolidated day rates for the three-month period ended September 30, 2015 decreased by 13 percent to $10,996.

In the 2015-quarter North American rig counts remained approximately 50 percent lower than the rig count experienced in the corresponding quarter in 2014. The Canadian industry continued to be dominated by horizontal and directional drilling, 96 percent of all wells drilled, and in the US the average number of horizontal and directional rigs running per day increased to 86 percent of all rigs running as compared to 80 percent in the third quarter of 2014. (Sources: Daily Oil Bulletin and Baker Hughes)

For the nine-month period ended September 30, 2015, consolidated revenue decreased by 37 percent to $230.6 million from $368.6 million in the comparable 2014-period. There were 18,020 consolidated operating days in the nine-month period ended September 30, 2015, which is 35 percent lower than the 27,730 days reported in the 2014-period.

# Operating Costs and Expenses

*(Stated in thousands of dollars except percentages)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| Direct costs | **66,641** | 107,927 | (38) | **222,198** | 294,904 | (25) |
| Gross profit as a percentage of revenue | **2%** | 22% | | **4%** | 20% | |
| Depreciation & amortization (included in direct costs) | **14,903** | 8,207 | 82 | **33,829** | 23,138 | 46 |
| Gross profit as percentage of revenue excluding depreciation & amortization | **24%** | 28% | | **18%** | 26% | |

Direct costs are comprised of field and shop expenses, and include depreciation and amortization on the Corporation's equipment. In the third quarter of 2015, gross profit as a percentage of revenue decreased to 2 percent from 22 percent in the 2014-quarter, and in the 2015 nine-month period decreased to 4 percent of revenue from 20 percent in the comparable 2014-period. The decrease in gross profit as a percentage of revenue was partly due to higher depreciation and amortization expenses in the three-month period ended September 30, 2015 which increased by 82 percent to $14.9 million as compared to $8.2 million in the 2014-quarter. The increase in depreciation and amortization expenses in the three and nine-month period ended September 30, 2015 was mainly the result of the Corporation's high level of capital expenditures in 2014. In addition in September, 2015, the Corporation reviewed the residual values of its drilling equipment and now expects it to be nil instead of its previous estimate of zero to 20 percent of acquisition cost. The effect of this change was an increase of $4.8 million in the depreciation expense for the 2015-quarter.

Excluding depreciation and amortization, gross profit as a percentage of revenue decreased to 24 percent for the three-month period ended September 30, 2015 from 28 percent in the comparable 2014-period. For the nine-month period ended September 30, 2015, gross profit as a percentage of revenue, excluding depreciation and amortization, was 18 percent of revenue as compared to 26 percent in 2014.

The decrease in margins in both the three and nine-month periods ended September 30, 2015 was, as in previous 2015-quarters, mainly due to lower activity and significant pricing pressures experienced in all of the Corporation's operating segments. In addition, as a result of Management's continued efforts to align the cost structure with activity levels, severance payments of $1.2 million and $3.9 million (included in direct costs) were incurred in the three and nine-month periods ended September 30, 2015, respectively.

Relative to the first and second quarter of the 2015-year, PHX Energy's profitability improved as gross profit as a percentage of revenue, excluding depreciation and amortization, increased to 24 percent in the third quarter of 2015 from 16 percent in both the first and second quarters of 2015. These positive results were largely driven by Management's implementation of several initiatives that were focused on optimizing resources, including the reduction of labor costs and improving equipment repair rates.

For the three-month period ended September 30, 2015, the Corporation's third party equipment rentals were 4 percent of consolidated revenue, which is the same percentage as in the corresponding 2014-quarter.

*(Stated in thousands of dollars except percentages)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| Selling, general & administrative ("SG&A") costs | **8,892** | 13,973 | (36) | **29,619** | 43,101 | (31) |
| Equity-settled share-based payments (included in SG&A costs) | **285** | 207 | 38 | **819** | 621 | 32 |
| SG&A costs excluding equity-settled share-based payments as a percentage of revenue | **13%** | 10% | | **12%** | 12% | |

SG&A costs for the three-month period ended September 30, 2015 decreased by 36 percent to $8.9 million as compared to $14.0 million in 2014. Included in SG&A costs for the 2015 and 2014-quarters are equity-settled share-based payments of $0.3 million and $0.2 million, respectively. Excluding these costs, SG&A costs as a percentage of consolidated revenue for the three-month periods ended September 30, 2015 and 2014 were 13 percent and 10 percent, respectively. Also included in SG&A costs for the three and nine-month periods ended September 30, 2015 were severance costs of $0.1 million and $1.5 million, respectively.

In the 2015-periods, SG&A costs incurred in dollar terms decreased mainly as a result of initiatives carried out to align the Corporation's cost structure with the lower activity in all regions. These initiatives included reductions to personnel related costs and tightened policies on travel, entertainment, and marketing related costs. In addition, in the 2015-periods the SG&A costs were less as a result of lower compensation expenses related to the cash-settled share-based retention awards, which are valued based on the price of PHX Energy's shares.

Equity-settled share-based payments relate to the amortization of the fair values of issued options of the Corporation using the Black-Scholes model. In the three and nine-month periods ended September 30, 2015, equity-settled share-based payments increased by 38 and 32 percent, respectively, as compared to the corresponding 2014-periods, generally due to compensation expenses related to options that were granted at the end of March, 2015.

Cash-settled share-based retention awards, which are included in SG&A costs, are measured at fair value, and in the 2015-quarter, the related compensation expense recognized by PHX Energy decreased to a recovery of $0.7 million as compared to a recovery of $0.3 million in the 2014-quarter. The decrease is primarily due to the re-valuation of the retention awards based on the decrease in PHX Energy's stock price from $5.48 as at June 30, 2015 to $2.85 as at September 30, 2015.

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| Provision for settlement of litigations | **5,555** | - | n.m. | **6,533** | - | n.m. |

n.m. - not meaningful

In September, 2015, Phoenix USA and the parties to the collective and class actions in the US entered into a settlement agreement wherein the parties have agreed for the full and final release and dismissal of all claims and allegations made in the collective and class actions, by the establishment of a US$5.0 million (equivalent to CDN$6.5 million) settlement fund. As a result, an additional $5.6 million was recognized as provision for the settlement of litigations in the three-month period ended September 30, 2015.

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| Research & development expense | **615** | 915 | (33) | **1,789** | 2,413 | (26) |

Research and development ("R&D") expenditures charged to net earnings during the three-month periods ended September 30, 2015 and 2014 were $0.6 million and $0.9 million, respectively. During both the 2015 and 2014-quarters, none of the R&D expenditures were capitalized as development costs.

For the nine-month period ended September 30, 2015, R&D expenditures incurred decreased by 26 percent to $1.8 million from $2.4 million in the corresponding 2014-period.

The decrease in R&D expenditures in both 2015-periods is primarily due to the reduction of personnel related costs in the R&D department and the receipt of $0.3 million in scientific research and experimental development tax credits in the second quarter of 2015.

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| Finance expense | **698** | 1,033 | (32) | **2,830** | 2,925 | (3) |

Finance expenses relate to interest charges on the Corporation's long-term and short-term bank facilities. As expected, finance charges decreased to $0.7 million in the third quarter of 2015 from $1.0 million in the 2014-quarter, and in the nine-month period ended September 30, 2015 decreased to $2.8 million from $2.9 million in the 2014-period. The decrease in both periods was primarily due to the lower amount of borrowings outstanding during the three and nine-month periods ended September 30, 2015 that resulted from significant repayments made in the 2015-periods.

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| Impairment losses on goodwill and intangible assets | **13,824** | - | n.m. | **13,824** | - | n.m. |

n.m. - not meaningful

In the third quarter of 2015, the Corporation determined that the continuation of the industry downturn and the delay in the expected recovery of the oil prices were indicators of impairment as they would impact future activity levels. As such an impairment test was performed on the Corporation's Canadian and Stream CGUs. Based on the results of the impairment tests, an impairment loss of $13.8 million related to the Stream CGU was recognized in the three-month period ended September 30, 2015 (2014 - nil). Of the impairment loss, $7.3 was allocated to goodwill and $6.5 million was allocated to intangible assets, which are comprised of $5.8 million relating to an old version of the EDR technology and $0.7 million relating to a customer relationship.

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | Nine-month periods ended September 30, | |
|---|---|---|---|---|
| | **2015** | 2014 | **2015** | 2014 |
| Loss (Gain) on disposition of drilling equipment | **4,280** | (607) | **3,673** | (3,870) |
| Foreign exchange losses (gains) | **(638)** | (858) | **(807)** | (466) |
| Provision for bad debts | **-** | 278 | **38** | 1,013 |
| Other expenses (income) | **3,642** | (1,187) | **2,904** | (3,323) |

For the three and nine-month periods ended September 30, 2015, other expenses is primarily comprised of losses on the disposition of drilling equipment of $4.3 million (2014 - gain of $0.6 million) and $3.7 million (2014 – gain of $3.9 million), respectively. Losses typically result from any asset retirements that were made before the end of the equipment's useful life and self-insured down hole equipment losses. Gains typically result from insurance programs undertaken whereby proceeds for the lost equipment are at current replacement values, which are higher than the respective equipment's book value. In the 2015-periods, the loss on disposition of drilling equipment resulted primarily from decommissioning a number of performance drilling motors for the purpose of utilizing the spare parts to service the remainder of the performance drilling motor fleet.

Offsetting other expenses for the three and nine-month periods ended September 30, 2015 is foreign exchange gains of $0.6 million (2014 - $0.9 million) and $0.8 million (2014 - $0.5 million), respectively, which resulted mainly from the revaluation of Canadian-denominated intercompany payables in the US. The US dollar strengthened against the Canadian dollar during the 2015-periods.

*(Stated in thousands of dollars, except percentages)*

| | Three-month periods ended September 30, | | Nine-month periods ended September 30, | |
|---|---|---|---|---|
| | **2015** | 2014 | **2015** | 2014 |
| Provision for (Recovery of) income taxes | **(7,123)** | 3,286 | **(10,348)** | 7,792 |
| Effective tax rates | **23%** | 20% | **21%** | 27% |

The recovery of income taxes for the three-month period ended September 30, 2015 was $7.1 million as compared to a provision for income taxes of $3.3 million in the 2014-quarter. For the nine-month period ended September 30, 2015, the recovery of income taxes was $10.3 million as compared to a provision for income taxes of $7.8 million in the corresponding 2014-period. The Government of Alberta increased the corporate income tax rate from 10 percent to 12 percent, resulting in a blended corporate tax rate of 11 percent for the year ended December 31, 2015. This was substantively enacted in June, 2015. As a result, the expected combined Canadian federal and provincial tax rate for 2015 was increased to 26 percent. The effective tax rates in the 2015-periods were lower than the expected rates primarily due to the non-deductibility of the goodwill impairment for tax purposes.

# Segmented Information:

The Corporation reports three operating segments on a geographical basis throughout the Canadian provinces of Alberta, Saskatchewan, British Columbia, and Manitoba; throughout the Gulf Coast, Northeast and Rocky Mountain regions of the US; and internationally, mainly in Albania and Russia.

## Canada

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| Revenue | **19,499** | 51,111 | (62) | **69,319** | 131,359 | (47) |
| Reportable segment profit (loss) before tax | **(19,880)** | 11,432 | n.m. | **(29,361)** | 14,537 | n.m. |

n.m. - not meaningful

PHX Energy's Canadian revenue for the three-month period ended September 30, 2015 decreased by 62 percent to $19.5 million from $51.1 million in the corresponding 2014-period. The decrease was generally due to weak industry activity and lower day rates realized in the 2015-quarter. In the third quarter of 2015, the Canadian segment reported 2,075 operating days, a 55 percent decrease from the 4,606 days in the 2014-period. In comparison, total industry horizontal and directional drilling activity, as measured by drilling days, declined by 49 percent in the 2015-quarter to 16,113 days from 31,828 days in the 2014-quarter. (Source: Daily Oil Bulletin) Average day rates also continued to decline and in the 2015-quarter they decreased by 15 percent to $9,067 from $10,698 in the 2014-quarter, excluding Stream revenue of $0.7 million.

Despite of these lower activity levels, the Canadian division maintained its healthy market share and a well-diversified client base. During the 2015-quarter, the Corporation's activity was weighted towards oil well drilling, 85 percent of wells drilled, and PHX Energy was active in the Montney, Wilrich, Bakken, Shaunavon, and Viking areas.

For the nine-month period of 2015, PHX Energy's Canadian revenue decreased by 47 percent to $69.3 million from $131.4 million in the comparable 2014-period. The Corporation's operating days decreased by 41 percent to 6,843 days in the 2015 nine-month period from 11,661 days in the 2014-period. In comparison, the number of horizontal and directional drilling days realized in the Canadian industry for the nine-month period ended September 30, 2015 decreased by 44 percent to 49,356 days as compared to 87,707 days in the nine-month period of 2014. (Sources: Daily Oil Bulletin)

The Canadian operations' reportable segment loss before tax for the third quarter of 2015 was $19.9 million as compared to a reportable segment profit before tax of $11.4 million in the 2014-quarter. For the nine-month period ended September 30, 2015, reportable segment loss before tax was $29.4 million as compared to a reportable segment profit before tax of $14.5 million in the 2014-period.

Included in the Canadian segment's losses in the three and nine-month period ended September 30, 2015 were losses of $15.3 million (2014 - $1.9 million) and $20.1 million (2014 - $4.5 million), respectively, from the Stream division. The Stream division's losses in the 2015-periods primarily resulted from the recognition of $13.8 million in impairment losses on goodwill and intangible assets. In addition, nil and $1.1 million in severance costs were incurred in the Stream division for the three and nine-month periods of 2015, respectively.

During the 2015-periods, the Canadian segment's profitability was also negatively affected by a change in the estimate of the residual values of its drilling equipment, which resulted in $4.8 million of additional depreciation expense.

## United States

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| Revenue | **42,521** | 75,985 | (44) | **142,498** | 199,294 | (28) |
| Reportable segment profit (loss) before tax | **(1,797)** | 5,319 | (134) | **(7,754)** | 16,930 | (146) |

In the third quarter of 2015, revenue from PHX Energy's US operations decreased by 44 percent to $42.5 million from $76.0 million in the 2014-quarter. The decrease mainly resulted from the significantly reduced industry rig count. In the third quarter of 2015, the number of horizontal and directional rigs running per day decreased by 52 percent from an average of 1,531 horizontal and directional rigs running per day during the 2014-quarter to 742 in the 2015-quarter. (Source: Baker Hughes) In comparison, the Corporation's US activity levels also weakened as operating days decreased by 47 percent from 4,956 days in the 2014-quarter to 2,612 days in the 2015-quarter. Generally due to the positive impact of a stronger US dollar, average day rates, excluding the motor rental division in Midland, Texas and the Rocky Mountain region, increased to $15,725 in the 2015-quarter compared to $14,476 in the 2014-period. Excluding the effects of foreign exchange, the average day rates actually decreased by 9 percent to $13,099 in the 2015-quarter, primarily as a result of the competitive pricing environment.

Horizontal and directional drilling represented 86 percent of the average number of rigs running on a daily basis in the third quarter of 2015 which was 6 percent greater than the percentage in 2014. For the three-month period ended September 30, 2015, oil well drilling, as measured by wells drilled and excluding the motor rental and gyro surveying divisions, increased to 65 percent of PHX Energy's US activity. During the third quarter of 2015, Phoenix USA remained active in the Permian, Eagle Ford, Bakken, Mississippian/Woodford, Marcellus, Niobrara and Utica basins and market share increased slightly in all US regions.

For the nine-month period ended September 30, 2015, US revenue decreased by 28 percent to $142.5 million from $199.3 million in the comparable 2014-period. US operating days in the 2015 nine-month period decreased by 32 percent to 9,042 days from 13,241 days in the 2014-period. In comparison, US industry activity, as measured by the average number of horizontal and directional rigs running on a daily basis, decreased by 38 percent in the nine-month period of 2015 to 907 rigs from 1,461 rigs in the comparable 2014-period. (Source: Baker Hughes)

Reportable segment loss before tax for the three-month period ended September 30, 2015 was $1.8 million compared to a reportable segment profit before tax of $5.3 million (7 percent of revenue) in the 2014-quarter. For the nine-month period ended September 30, 2015, reportable segment loss before tax was $7.8 million compared to a reportable segment profit before tax of $16.9 million (8 percent of revenue) in the comparative 2014-period. As in the previous 2015-quarters, decreased profitability in the 2015-periods was largely the result of weaker activity levels and lower average day rates.

## International

*(Stated in thousands of dollars, except percentages)*

| | Three-month periods ended September 30, | | | Nine-month periods ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2015** | 2014 | % Change | **2015** | 2014 | % Change |
| Revenue | **6,207** | 11,875 | (48) | **18,825** | 37,933 | (50) |
| Reportable segment profit before tax | **797** | 2,586 | (69) | **3,554** | 7,876 | (55) |
| Reportable segment profit before tax as a percentage of revenue | **13%** | 22% | | **19%** | 21% | |

For the three-month period ended September 30, 2015, the Corporation's international revenue decreased by 48 percent to $6.2 million from the $11.9 million generated in the 2014-period. International operating days decreased by 22 percent from 901 days in the 2014-quarter to 700 days in the 2015-quarter. The Corporation generated 9 percent of its consolidated revenue from its international operations in the 2015-quarter, which is the same percentage as in the 2014-quarter.

For the nine-month period ended September 30, 2015, revenue decreased by 50 percent to $18.8 million from $37.9 million in the comparable 2014-period. International operating days in the nine-month period of 2015 were 2,135 days, 25 percent lower compared to the 2,828 days generated in the 2014-period.

The Albanian division remained active on two rigs for the majority of the quarter with occasional services delivered to a local operator. For the three-month period ended September 30, 2015 activity decreased 60 percent as compared to the corresponding 2014-quarter. Despite the steep decline in activity and additional pricing concessions that took place in the 2015-quarter, the Albanian operations remained profitable. Efforts to reduce the cost base have been successful and maximizing the use of local staff where possible has also had a positive impact to the financial results of the operation. Initiatives to optimize equipment through collaborative efforts with clients have also helped deliver improved operational and financial performance.

PHX Energy's Russian operations continued to benefit from its long term initiatives to diversify its client base and in the third quarter of 2015, the division reported a 26 percent increase in activity compared to the 2014-period, despite low commodity prices and the prevailing economic and geopolitical climate in Russia. As a result of increased activity, profitability for this division also improved, despite the negative impact of the further devaluation of the Russian Ruble against the Canadian dollar.

Reportable segment profit from international operations for the three-month period ended September 30, 2015 was $0.8 million (13 percent of revenue), which is 69 percent lower than the $2.6 million (22 percent of revenue) generated in the corresponding 2014-period. Reportable segment profit for the nine-month period ended September 30, 2015 was $3.6 million (19 percent of revenue) as compared to $7.9 million (21 percent of revenue) in the 2014-period; a 55 percent decrease. The decrease in the international operations' profitability in both 2015-periods was mainly due to weaker activity levels in Albania.

# Summary of Quarterly Results

*(Stated in thousands of dollars except per share amounts)*

| | **Sept-15** | Jun-15 | Mar-15 | Dec-14 | Sept-14 | Jun-14 | Mar-14 | Dec-13 |
|---|---|---|---|---|---|---|---|---|
| Revenue | **68,227** | 58,487 | 103,928 | 152,881 | 138,971 | 100,484 | 129,131 | 115,543 |
| Net earnings (loss) | **(24,515)** | (8,294) | (5,898) | 1,220 | 13,024 | (1,062) | 8,813 | 22,259 |
| Earnings (Loss) per share – basic | **(0.59)** | (0.23) | (0.17) | 0.03 | 0.37 | (0.03) | 0.26 | 0.69 |
| Earnings (Loss) per share – diluted | **(0.59)** | (0.23) | (0.17) | 0.03 | 0.37 | (0.03) | 0.25 | 0.68 |
| Adjusted EBITDA | **8,906** | 1,218 | 6,934 | 29,039 | 25,889 | 7,024 | 20,283 | 14,908 |
| Funds from operations | **677** | 340 | 3,299 | 28,543 | 26,702 | 6,504 | 20,515 | 15,161 |

Activity levels in western Canada vary considerably due to seasonal weather patterns. Traditionally, the first quarter of the calendar year is the most active for service companies due to cold weather. The ability to move heavy equipment in the Canadian oil and natural gas fields is dependent on weather conditions. As warm weather returns in the spring, the winter's

frost comes out of the ground rendering many secondary roads incapable of supporting the weight of heavy equipment until they have thoroughly dried out. The duration of this "spring break-up" has a direct impact on the Corporation's activity levels. As a result, late March through May is traditionally the Corporation's slowest time, as such, the operating results of the Corporation vary on a quarterly basis. The Corporation's activity levels in the US and international regions are not impacted at the same level during this Canadian spring break-up period.

# Liquidity

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | Nine-month periods ended September 30, | |
|---|---|---|---|---|
| | **2015** | 2014 | **2015** | 2014 |
| Funds from operations | **677** | 26,702 | **4,317** | 53,720 |

| | **Sept. 30, '15** | Dec. 31, '14 |
|---|---|---|
| Working capital | **59,809** | 80,974 |

Funds from operations decreased from $26.7 million in the 2014-quarter to $0.7 million in the three-month period ended September 30, 2015. For the nine-month period ended September 30, 2015, the funds from operations decreased to $4.3 million from $53.7 million in the comparable 2014-period. The decrease in funds from operations in both 2015-periods was generally due to the decline in activity levels in all of the Corporation's regions that resulted primarily from the continued weak commodity prices in the third quarter of 2015.

As at September 30, 2015, the Corporation had working capital of $59.8 million, which was $21.2 million lower than the $81.0 million reported at December 31, 2014. The decrease in working capital was mainly due to the lower level of trade receivables at September 30, 2015 which resulted largely from decreased revenues in the 2015-periods.

On October 16, 2015, the Corporation's credit agreement with its syndicate of lenders was amended. One of the key amendments was to reduce the maximum principal amounts available to the Corporation under its syndicated and US operating facilities from CDN$160 million to CDN$90 million and US$25 million to US$2.5 million, respectively. The purpose of the decrease was to reduce the standby fees charged on unused balances under the credit facilities. Based on the reduced amounts of the credit facilities, the Corporation had approximately CAD$34.7 million and US$2.5 million available to be drawn from its credit facilities as at September 30, 2015.

## Cash Flow and Dividends

The Corporation continually reviews its dividend rates on a quarterly basis and takes into consideration its own financial performance, forecasted activity levels and the industry outlook. The actual amount of future quarterly dividends is proposed by Management and is subject to the approval of the Board. The Board reviews future dividends in conjunction with their review of quarterly financial and operating results. The Corporation's ability to maintain the current level of dividends to its shareholders is dependent upon the realization of cash flow from operations, and if the Corporation does not meet its budgeted cash flow from operations, dividends to shareholders may be reduced. Activity levels in the industry are seasonal, and as a result, cash flow will fluctuate.

Under the Corporation's credit agreement with its bank, PHX Energy is subject to a negative covenant which limits the annual dividends based on the amount of its yearly distributable cash flow, defined under the credit agreement as covenant EBITDA for the year less maintenance capital expenditures, scheduled principal repayments of debt, interest expense paid, and income taxes paid. Based on the amendments to the credit agreement effective October 16, 2015, this negative covenant shall not apply to the financial year ended December 31, 2015. In addition, during the covenant relief period through to December 31, 2016, there will be no increases permitted in the rate of dividends payable by the Corporation.

For the three-month period ended September 30, 2015, dividends of $2.2 million (2014 - $7.4 million) were financed mainly from the Corporation's cash flow from operations.

# Investing Activities

Net cash used in investing activities for the three-month period ended September 30, 2015 was $8.1 million as compared to $16.0 million in 2014. In the third quarter of 2015, PHX Energy added $1.7 million, net, in capital equipment (2014 - $27.9 million). The capital equipment amounts are net of proceeds from the involuntary disposal of drilling equipment in well bores of $0.7 million (2014 - $3.3 million). The quarterly 2015 expenditures included:

- $1.6 million in MWD systems and spare components;
- $0.3 million in machinery and equipment;
- $0.3 million in down hole performance drilling motors; and
- $0.1 million in leasehold improvements.

The capital expenditure program undertaken in the period was financed generally from working capital.

During the 2015-quarter, the Corporation spent $5.7 million in intangible assets, $5.5 million of which related to a license agreement and $0.2 million related to development costs. The change in non-cash working capital balances of $0.7 million (use of cash) for the three-month period ended September 30, 2015, relates to the net change in the Corporation's trade payables that are associated with the acquisition of capital assets. This compares to $12.5 million (source of cash) for the three-month period ended September 30, 2014.

# Financing Activities

The Corporation reported cash flows used in financing activities of $3.2 million in the three-month period ended September 30, 2015 as compared to cash flows from financing activities of $18.1 million in the 2014-period. In the 2015-quarter:

- through its DRIP program, the Corporation received cash proceeds of $80,000 from reinvested dividends to acquire 20,781 common shares of the Corporation;
- an additional $114,000 was incurred in transaction costs that related to the equity financing in June 30, 2015;
- the Corporation paid dividends of $2.2 million to shareholders, or $0.05 per share; and
- the Corporation made aggregate net repayments of $1.0 million on its operating and syndicated facilities.

# Capital Resources

As of September 30, 2015, the Corporation had $70.0 million drawn on its syndicated facility, $0.3 million drawn on its operating facility, and nil drawn on its US operating facility.

On October 16, 2015, the Corporation amended its credit agreement with its syndicate of lenders. The key amendments reflected the following revisions to PHX Energy's financial and negative covenants under its credit facilities (defined terms have the meanings ascribed thereto in the credit agreement, a copy of which can be found under PHX Energy's profile on SEDAR at www.sedar.com):

- The ratio of Debt to covenant EBITDA shall not exceed 5.0x for the quarters ending December 31, 2015, March 31, 2016, June 30, 2016 and September 30, 2016, shall not exceed 4.0x for the quarter ending December 31, 2016 and shall not exceed 3.0x for the quarter ending March 31, 2017, all calculated on a four quarter rolling basis.

- For the purposes of the calculation of the covenant EBITDA during the period from the quarter ended March 31, 2015 to the quarter ending March 31, 2016, PHX Energy shall be permitted to add back actual severance costs paid up to a maximum of CDN$5.0 million and settlement amounts to be paid (and provisions made in respect thereof) by the Corporation in respect of the US litigations to a maximum aggregate of CDN$6.5 million.

- The Corporation's negative covenant, which limits its annual dividends based on the amount of its yearly distributable cash flow, shall not apply to the financial year ending December 31, 2015. In addition, during the covenant relief period through to December 31, 2016, there will be no increases permitted in the rate of dividends payable by the Corporation.

- The maximum principal amounts available to the Corporation under each of the Syndicated Credit Facility and the U.S. Operating Facility were reduced from CDN$160 million to CDN$90 million and US$25 million to US$2.5 million, respectively.

In accordance with the amendments, effective September 30, 2015, EBITDA under the credit agreement (referred above as "covenant EBITDA"), was calculated as net earnings for a rolling four quarter period, adjusted for finance expense, provision for income taxes, depreciation and amortization, equity-settled share-based payments, unrealized foreign exchange losses, impairment losses on goodwill and intangible assets, loss on disposition of drilling equipment, severance costs, and provision for settlement of litigations, subject to the restrictions provided in the amended credit agreement.

As at September 30, 2015, the Corporation was in compliance with all its financial covenants.

## Cash Requirements for Capital Expenditures

Historically, the Corporation has financed its capital expenditures and acquisitions through cash flows from operating activities, debt and equity. In order to preserve cash flows, the 2015 capital budget has been decreased from the previously announced $28.3 million to $18.5 million. These planned expenditures are expected to be financed from a combination of one or more of the following: cash flow from operations, the Corporation's unused credit facilities or equity, if necessary. However, if a sustained period of market uncertainty and financial market volatility persists in 2015, the Corporation's activity levels, cash flows and access to credit may be negatively impacted, and the expenditure level would be reduced accordingly. Conversely, if future growth opportunities present themselves, the Corporation would look at expanding this planned capital expenditure amount.

# Contractual Obligations

The following table reflects the Corporation's anticipated payment of contractual obligations related to continuing operations as at September 30, 2015.

*(Stated in thousands of dollars)*

| | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|
| Operating facility | 303 | - | - | - | - |
| Loans and borrowings | - | - | - | 70,000 | - |
| Drilling and other equipment | 755 | - | - | - | - |
| Operating leases | 7,397 | 6,786 | 6,457 | 6,085 | 5,869 |
| Trade and other payables | 32,456 | - | - | - | - |
| Provisions | 2,178 | 4,355 | - | - | - |
| Dividends payable | 137 | - | - | - | - |
| Total | 43,226 | 11,141 | 6,457 | 76,085 | 5,869 |

# Provisions

a) As previously announced, Phoenix USA had been named in a collective legal action in Houston, Texas. The claimants alleged that they were improperly classified as exempt under the Fair Labour Standards Act and therefore entitled to unpaid overtime.

b) On February 20, 2015, Phoenix USA was named in a second collective legal action in Houston, Texas commenced by two former consultants and joined by one consultant (the "Claimants"), alleging that they were improperly classified as independent contractors (as opposed to employees) under the Fair Labor Standards Act and are entitled to unpaid overtime.

c) On May 29, 2015, Phoenix USA was named in a class legal action in Pittsburgh, Pennsylvania commenced by a former employee claiming that he was improperly classified as exempt under the Pennsylvania Minimum Wage Act ("PMWA") and therefore entitled to unpaid overtime. In this complaint, it was alleged that improper classification was imposed on similarly situated individuals (PMWA class members).

In September, 2015, Phoenix USA and the parties to the collective and class actions above entered into a settlement agreement wherein the parties have agreed for the full and final release and dismissal of all claims and allegations made in the collective and class actions, by the establishment of a US$5.0 million settlement fund, which shall be funded by the Corporation in three equal installments on November 2, 2015, January 1, 2016 and January 31, 2016. The settlement agreement includes all MWD operators employed by Phoenix USA, regardless of the states in which they worked and whether they had already joined one of the pending lawsuits. In October, 2015, the Corporation received the requisite court approval of the settlement agreement. During the nine-month period ended September 30, 2015, PHX Energy recognized a provision of $6.5 million for the settlement.

# Off-Balance Sheet Arrangements

The Corporation had no off-balance sheet arrangements as at September 30, 2015 and 2014, other than operating leases.

# Proposed Transactions

The Corporation reviews and evaluates any material business acquisitions or capital asset divestitures in the normal course of its operations.

# Critical Accounting Estimates

The consolidated interim financial statements have been prepared in accordance with IAS 34 Interim Financial Reporting. The Corporation's significant accounting policies are described in its annual audited consolidated financial statements for the year ended December 31, 2014. Management, in preparing these financial statements, is required to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. These estimates and judgments are based upon assumptions that are considered reasonable under the circumstances. Actual results could differ from such estimates and judgments by a material amount. The significant judgments made by Management in applying the Corporation's accounting policies and the key sources of estimation uncertainty have not changed significantly since December 31, 2014, except for:

- a change in the estimate relating to the residual values of drilling equipment; and
- a change in the estimates for key assumptions relating to the valuation of goodwill and intangible assets.

# Changes in Accounting Policies

The condensed consolidated interim financial statements have been prepared utilizing the same accounting policies and methods as the consolidated financial statements of the Corporation for the year ended December 31, 2014.

## New Standards and Interpretations Not Yet Adopted:

Certain new standards, interpretations, amendments and improvements to existing standards are effective for accounting periods beginning on after January 1, 2016. These standards have not been applied in preparing these condensed consolidated interim financial statements. Those which may be relevant to the Corporation are set out below.

### a) IFRS 9 Financial Instruments (2014)

IFRS 9, published in July 2014, replaces the existing guidance in IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 includes revised guidance on the classification and measurement of financial instruments, including a new expected credit loss model for calculating impairment on financial assets, and the new general hedge accounting requirements. It also carries forward the guidance on recognition and derecognition of financial instruments from IAS 39. IFRS 9 is effective for annual reporting periods beginning on or after January 1, 2018, with early adoption permitted. The Company intends to adopt IFRS 9 (2014) in its financial statements for the annual period beginning on January 1, 2018. The extent of the impact of adoption of the standard has not yet been determined.

### b) IFRS 15 Revenue from Contracts with Customers

IFRS 15 establishes a comprehensive framework for determining whether, how much and when revenue is recognized. It replaces existing revenue recognition guidance, including IAS 18 Revenue. IFRS 15 is effective for annual reporting periods beginning on or after January 1, 2018, with early adoption permitted. The Corporation intends to adopt IFRS 15 for the annual period beginning on January 1, 2018. The extent of the impact of adoption of the standard has not yet been determined.

# Business Risk Factors

The business risk factors applicable to the Corporation have not materially changed since December 31, 2014. Refer to the "Business Risk Factors" section of the MD&A in the PHX Energy's 2014 annual report.

# Corporate Governance

This MD&A has been prepared by the Management of PHX Energy and it has been reviewed and approved by the Audit Committee and the Board of Directors of the Corporation. Additional information relating to the Corporation's Corporate Governance can be found in the Corporation's Annual Information Form and Information Circular in respect of its annual meeting of shareholders, each of which are annually filed on SEDAR at www.sedar.com.

# Disclosure Controls and Procedures

The Corporation's Chief Executive Officer and Chief Financial Officer have designed, or caused to be designed under their supervision, disclosure controls and procedures to provide reasonable assurance that: (i) material information relating to the Corporation is made known to the Corporation's Chief Executive Officer and Chief Financial Officer by others, particularly during the period in which the interim filings are being prepared; and (ii) information required to be disclosed by the Corporation in its annual filings, interim filings or other reports filed or submitted by it under securities legislation is recorded, processed, summarized and reported within the time period specified in securities legislation.

# Internal Controls Over Financial Reporting

The Corporation's Chief Executive Officer and Chief Financial Officer have designed, or caused to be designed under their supervision, internal controls over financial reporting related to the Corporation, including its consolidated subsidiaries to provide reasonable assurance regarding the reliability of the Corporation's financial reporting and preparation of financial statements together with other financial information for external purposes in accordance with IFRS.

The Corporation is required to disclose herein any change in the Corporation's internal controls over financial reporting that occurred during the period beginning on July 1, 2015 and ending on September 30, 2015 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal controls over financial reporting. No material changes in the Corporation's internal controls over financial reporting were identified during such period that has materially affected, or are reasonably likely to materially affect, the Corporation's internal controls over financial reporting.

It should be noted that a control system, including the Corporation's disclosure and internal controls and procedures, no matter how well conceived, can provide only reasonable, but not absolute, assurance that the objectives of the control system will be met and it should not be expected that the disclosure and internal controls and procedures will prevent all errors or fraud.

# Outstanding Corporation Share Data

| *(In thousands of shares)* | **As at November 4, 2015** |
|---|---|
| Common shares outstanding | 41,567,023 |
| Dilutive securities: | |
| Options | 2,383,161 |
| Corporation shares – diluted | 43,950,184 |

# Outlook

The very challenging market conditions that have persisted in the drilling industry for the past year continued through the third quarter of 2015. Despite this difficult environment PHX Energy generated positive adjusted EBITDA in the third quarter of 2015, an accomplishment that required the Corporation to diligently implement many strategic cost initiatives throughout the 2015-year. Although many of the decisions were very difficult to make, the improvement in profitability in the third quarter as compared to the prior two quarters of the year demonstrates that the proactive measures taken were necessary.

Industry forecasts for North American activity show continued declines in oil and gas operating companies' capital expenditure programs for at least the first half of 2016. With limited access to capital markets and lower commodity prices persisting, cash flows are slowing for these operators and as a result they continue to decrease their drilling budgets, driving the active rig counts down in the drilling regions PHX Energy operates. This market contraction has caused pricing pressures to mount significantly.

Despite the combination of North American rig counts being approximately 50 percent lower than in 2014 and the extremely competitive environment, both PHX Energy's US and Canadian operations have maintained market share in the third quarter of 2015. In some areas the Corporation believes that market share will increase in future quarters as a result of the superior performance and quality of service PHX Energy provides.

In Albania, there are similar challenges to those in North America, and in the Russian market although the industry has remained relatively robust, the Corporation has been impacted by the effects of a dropping Russian Ruble. Nevertheless, international operations continue to contribute positive earnings to the Corporation's income.

The severity of the drop in the price of oil and the resulting collapse in the active drilling rig count has hit very hard. PHX Energy has reacted quickly and will continue to make adjustments accordingly to maintain its stable financial position. Today, the Corporation believes profitability can be sustained within the current market conditions and PHX Energy is focused on ensuring it is in a position to capture more market share at improved margins when the upswing takes hold.

Michael Buker
President
November 4, 2015

# Non-GAAP Measures

## 1) Adjusted EBITDA

Adjusted EBITDA, defined as earnings before finance expense, income taxes, depreciation and amortization, gain or loss on disposition of drilling equipment, impairment losses on goodwill and intangible assets, provisions for the settlement of litigations, and severance costs, is not a financial measure that is recognized under GAAP. However, Management believes that adjusted EBITDA provides supplemental information to net earnings that is useful in evaluating the results of the Corporation's principal business activities before considering other non-recurring charges, how it was financed and how it was taxed in various countries. Investors should be cautioned, however, that adjusted EBITDA should not be construed as an alternative measure to net earnings determined in accordance with GAAP. PHX Energy's method of calculating adjusted EBITDA may differ from that of other organizations and, accordingly, its adjusted EBITDA may not be comparable to that of other companies.

The following is a reconciliation of net earnings to adjusted EBITDA:

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | Nine-month periods ended September 30, | |
|---|---|---|---|---|
| | **2015** | 2014 | **2015** | 2014 |
| Net earnings (loss) | **(24,515)** | 13,024 | **(38,707)** | 20,775 |
| Add: | | | | |
| Depreciation and amortization | **14,903** | 8,207 | **33,829** | 23,138 |
| Provision for (Recovery of) income taxes | **(7,123)** | 3,287 | **(10,348)** | 7,792 |
| Finance expense | **697** | 1,033 | **2,830** | 2,925 |
| Loss (Gain) on disposition of drilling equipment | **4,280** | (607) | **3,673** | (3,870) |
| Impairment losses on goodwill and intangible assets | **13,823** | - | **13,824** | - |
| Provision for settlement of litigations | **5,555** | - | **6,533** | |
| Severance costs | **1,286** | 945 | **5,424** | 2,437 |
| Adjusted EBITDA as reported | **8,906** | 25,889 | **17,058** | 53,197 |

Adjusted EBITDA per share - diluted is calculated using the treasury stock method whereby deemed proceeds on the exercise of the share options are used to reacquire common shares at an average share price. The calculation of adjusted EBITDA per share on a dilutive basis does not include anti-dilutive options.

## 2) Funds from Operations

Funds from operations is defined as cash flows generated from operating activities before changes in non-cash working capital, interest paid, and income taxes paid. This is not a measure recognized under GAAP. Management uses funds from operations as an indication of the Corporation's ability to generate funds from its operations before considering changes in working capital balances and interest and taxes paid. Investors should be cautioned, however, that this financial measure should not be construed as an alternative measure to cash flows from operating activities determined in accordance with GAAP. PHX Energy's method of calculating funds from operations may differ from that of other organizations and, accordingly, it may not be comparable to that of other companies.

The following is a reconciliation of cash flows from operating activities to funds from operations:

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | Nine-month periods ended September 30, | |
|---|---|---|---|---|
| | **2015** | 2014 | **2015** | 2014 |
| Cash flows from operating activities | **10,780** | (1,735) | **42,950** | 17,664 |
| Add (deduct): | | | | |
| Changes in non-cash working capital | **(9,994)** | 26,759 | **(42,750)** | 31,877 |
| Interest paid | **575** | 1,152 | **2,339** | 2,780 |
| Income taxes received | **(684)** | 526 | **1,778** | 1,399 |
| Funds from operations | **677** | 26,702 | **4,317** | 53,720 |

Funds from operations per share - diluted is calculated using the treasury stock method whereby deemed proceeds on the exercise of the share options are used to reacquire common shares at an average share price. The calculation of funds from operations per share on a dilutive basis does not include anti-dilutive options.

## 3) Debt to covenant EBITDA Ratio

Debt is represented by loans and borrowings. Covenant EBITDA, for purposes of the calculation of this covenant ratio, is represented by net earnings for a rolling four quarter period, adjusted for finance expense, provision for income taxes, depreciation and amortization, equity-settled share-based payments, unrealized foreign exchange losses, impairment losses on goodwill and intangible assets, loss on disposition of drilling equipment, severance costs, and provision for settlement of litigations, subject to the restrictions provided in the amended loan agreement.

# Condensed Consolidated Statements of Financial Position

*(unaudited)*

| | September 30, 2015 | December 31, 2014 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | **$ 2,871,322** | $ 3,018,445 |
| Trade and other receivables | **55,693,692** | 122,272,125 |
| Inventories | **32,642,280** | 32,423,158 |
| Current tax receivables | **4,580,944** | - |
| Prepaid expenses | **3,450,291** | 4,505,300 |
| Total current assets | **99,238,529** | 162,219,028 |
| Non-current assets: | | |
| Drilling and other equipment (Note 6) | **179,123,119** | 190,891,854 |
| Goodwill | **8,876,351** | 16,229,756 |
| Intangible assets | **25,830,658** | 25,581,960 |
| Deferred tax assets | **180,832** | - |
| Total non-current assets | **214,010,960** | 232,703,570 |
| Total assets | **$ 313,249,489** | $ 394,922,598 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Operating facility | **$ 302,930** | $ 5,503,176 |
| Trade and other payables | **32,456,428** | 72,203,463 |
| Provisions (Note 10) | **6,533,426** | - |
| Dividends payable (Note 11b) | **137,167** | 2,466,649 |
| Current tax liabilities | **-** | 832,352 |
| Current portion of finance leases | **-** | 238,911 |
| Total current liabilities | **39,429,951** | 81,244,551 |
| Non-current liabilities: | | |
| Loans and borrowings (Note 9) | **70,000,000** | 104,280,800 |
| Deferred tax liabilities | **-** | 7,602,868 |
| Deferred income | **1,733,336** | 1,833,335 |
| Total non-current liabilities | **71,733,336** | 113,717,003 |
| Equity: | | |
| Share capital (Note 11a) | **213,553,012** | 178,650,340 |
| Contributed surplus | **5,331,779** | 4,513,265 |
| Retained earnings | **(32,196,409)** | 16,861,918 |
| Accumulated other comprehensive income | **15,397,820** | (64,479) |
| Total equity | **202,086,202** | 199,961,044 |
| Total liabilities and equity | **$ 313,249,489** | $ 394,922,598 |

*See accompanying notes to unaudited condensed consolidated interim financial statements.*

# Condensed Consolidated Statements of Comprehensive Income

*(unaudited)*

| | Three-month periods ended September 30, | | Nine-month periods ended September 30, | |
|---|---|---|---|---|
| | **2015** | 2014 | **2015** | 2014 |
| Revenue | **$ 68,227,342** | $ 138,971,376 | **$ 230,641,748** | $ 368,586,036 |
| Direct costs | **66,640,879** | 107,926,830 | **222,198,203** | 294,903,700 |
| Gross profit | **1,586,463** | 31,044,546 | **8,443,545** | 73,682,336 |
| Expenses: | | | | |
| Selling, general and administrative expenses | **8,891,741** | 13,972,945 | **29,619,318** | 43,100,832 |
| Provision for the settlement of litigations | **5,555,453** | - | **6,533,426** | - |
| Research and development expenses | **614,745** | 915,228 | **1,789,359** | 2,412,698 |
| Finance expense | **697,513** | 1,032,864 | **2,829,747** | 2,924,905 |
| Impairment losses on goodwill and intangible assets (Notes 7 and 8) | **13,823,514** | - | **13,823,514** | - |
| Other expenses (income) (Note 12) | **3,642,073** | (1,187,049) | **2,903,859** | (3,323,134) |
| | **33,225,039** | 14,733,988 | **57,499,223** | 45,115,301 |
| Earnings (Loss) before income taxes | **(31,638,576)** | 16,310,558 | **(49,055,678)** | 28,567,035 |
| Provision for (Recovery of) income taxes | | | | |
| Current | **(2,541,157)** | 8,463,268 | **(1,562,740)** | 11,049,447 |
| Deferred | **(4,581,993)** | (5,176,828) | **(8,785,661)** | (3,257,212) |
| | **(7,123,150)** | 3,286,440 | **(10,348,401)** | 7,792,235 |
| Net earnings (loss) | **(24,515,426)** | 13,024,118 | **(38,707,277)** | 20,774,800 |
| Other comprehensive income | | | | |
| Foreign currency translation | **5,767,432** | 585,625 | **15,462,299** | (92,270) |
| Total comprehensive income (loss) for the period | **$ (18,747,994)** | $ 13,609,743 | **$ (23,244,978)** | $ 20,682,530 |
| Earnings (Loss) per share – basic | **$ (0.59)** | $ 0.37 | **$ (1.03)** | $ 0.60 |
| Earnings (Loss) per share – diluted | **$ (0.59)** | $ 0.37 | **$ (1.03)** | $ 0.59 |

*See accompanying notes to unaudited condensed consolidated interim financial statements.*

# Condensed Consolidated Statements of Changes in Equity

*(unaudited)*

| Nine-month period ended September 30, 2015 | Share Capital Number | Share Capital Amount ($) | Contributed Surplus | Accumulated Other Comprehensive Income | Retained Earnings | Total Equity |
|---|---|---|---|---|---|---|
| **Balance, December 31, 2014** | **35,237,839** | **$ 178,650,340** | **$ 4,513,265** | **$ (64,479)** | **$ 16,861,918** | **$ 199,961,044** |
| **Issuance of share capital (Note 11a)** | **6,327,888** | **34,902,672** | **-** | **-** | **-** | **34,902,672** |
| **Share-based payments** | **-** | **-** | **818,514** | **-** | **-** | **818,514** |
| **Net loss** | **-** | **-** | **-** | **-** | **(38,707,277)** | **(38,707,277)** |
| **Foreign currency translation** | **-** | **-** | **-** | **15,462,299** | **-** | **15,462,299** |
| **Dividends** | **-** | **-** | **-** | **-** | **(10,351,050)** | **(10,351,050)** |
| **Balance, September 30, 2015** | **41,565,727** | **$ 213,553,012** | **$ 5,331,779** | **$ 15,397,820** | **$ (32,196,409)** | **$ 202,086,202** |

| Nine-month period ended September 30, 2014 | Share Capital Number | Share Capital Amount ($) | Contributed Surplus | Accumulated Other Comprehensive Income | Retained Earnings | Total Equity |
|---|---|---|---|---|---|---|
| Balance, December 31, 2013 | 34,218,974 | $ 165,451,599 | $ 6,361,710 | $ 2,379,019 | $ 24,284,690 | $ 198,477,018 |
| Issuance of share capital | 898,550 | 9,451,805 | - | - | - | 9,451,805 |
| Share-based payments | - | - | 621,086 | - | - | 621,086 |
| Fair value of options exercised | - | 2,543,811 | (2,543,811) | - | - | - |
| Net earnings | - | - | - | - | 20,774,800 | 20,774,800 |
| Foreign currency translation | - | - | - | (92,270) | - | (92,270) |
| Dividends | - | - | - | - | (22,026,285) | (22,026,285) |
| Balance, September 30, 2014 | 35,117,524 | $ 177,447,215 | $ 4,438,985 | $ 2,286,749 | $ 23,033,205 | $ 207,206,154 |

*See accompanying notes to unaudited condensed consolidated interim financial statements.*

# Condensed Consolidated Statements of Cash Flows

*(unaudited)*

| | Three-month periods ended September 30, | | Nine-month periods ended September 30, | |
|---|---|---|---|---|
| | **2015** | 2014 | **2015** | 2014 |
| Cash flows from operating activities: | | | | |
| Net earnings (loss) | **$ (24,515,426)** | $ 13,024,118 | **$ (38,707,277)** | $ 20,774,800 |
| Adjustments for: | | | | |
| Depreciation and amortization | **14,902,807** | 8,207,226 | **33,829,413** | 23,138,397 |
| Provision for (Recovery of) income taxes | **(7,123,150)** | 3,286,440 | **(10,348,401)** | 7,792,235 |
| Unrealized foreign exchange loss (gain) | **(661,676)** | 1,306,465 | **(1,540,156)** | 1,426,506 |
| Loss (Gain) on disposition of drilling equipment | **4,279,862** | (606,813) | **3,672,988** | (3,870,138) |
| Impairment loss on goodwill and intangible assets | **13,823,514** | - | **13,823,514** | - |
| Equity-settled share-based payments | **285,279** | 207,002 | **818,514** | 621,086 |
| Finance expense | **697,513** | 1,032,864 | **2,829,747** | 2,924,905 |
| Amortization of deferred income | **(33,333)** | (33,333) | **(99,999)** | (99,999) |
| Provision for bad debts | **-** | 277,608 | **38,407** | 1,012,706 |
| Other non-cash charges | **(977,973)** | - | **-** | - |
| Change in non-cash working capital | **9,994,349** | (26,758,743) | **42,750,091** | (31,876,958) |
| Cash generated from (used in) operating activities | **10,671,766** | (57,166) | **47,066,841** | 21,843,540 |
| Interest paid | **(575,969)** | (1,152,572) | **(2,339,511)** | (2,780,046) |
| Income taxes received (paid) | **684,449** | (525,625) | **(1,777,689)** | (1,399,058) |
| Net cash from (used in) operating activities | **10,780,246** | (1,735,363) | **42,949,641** | 17,664,436 |
| Cash flows from investing activities: | | | | |
| Proceeds on disposition of drilling equipment | **653,040** | 3,343,466 | **3,322,993** | 10,748,952 |
| Acquisition of drilling and other equipment | **(2,338,258)** | (31,236,057) | **(17,155,565)** | (55,761,391) |
| Acquisition of intangible assets | **(5,676,534)** | (646,611) | **(7,862,039)** | (8,531,427) |
| Change in non-cash working capital | **(723,817)** | 12,539,486 | **(3,459,060)** | 8,376,881 |
| Net cash used in investing activities | **(8,085,569)** | (15,999,716) | **(25,153,671)** | (45,166,985) |
| Cash flows from financing activities: | | | | |
| Proceeds from (Payments for) issuance of share capital (net) | **(34,018)** | 1,756,371 | **34,311,343** | 9,451,805 |
| Dividends paid to shareholders | **(2,181,391)** | (7,355,760) | **(12,680,532)** | (21,807,987) |
| Proceeds from (Repayment of) loans and borrowings | **3,000,000** | 17,000,000 | **(34,280,800)** | 37,000,000 |
| Payments under finance leases | **(5,478)** | (42,477) | **(92,858)** | (143,556) |
| Proceeds from (Repayment of) operating facility | **(4,001,344)** | 6,783,087 | **(5,200,246)** | 6,783,087 |
| Net cash from (used in) financing activities | **(3,222,231)** | 18,141,221 | **(17,943,093)** | 31,283,349 |
| Net increase (decrease) in cash and cash equivalents | **(527,554)** | 406,142 | **(147,123)** | 3,780,800 |
| Cash and cash equivalents, beginning of period | **3,398,876** | 9,038,538 | **3,018,445** | 5,663,880 |
| Cash and cash equivalents, end of period | **$ 2,871,322** | $ 9,444,680 | **$ 2,871,322** | $ 9,444,680 |

*See accompanying notes to unaudited condensed consolidated interim financial statements.*

# Notes to the Condensed Consolidated Financial Statements

## For the three and nine-month periods ended September 30, 2015 and 2014

In Canadian dollars *(unaudited)*

## 1. Reporting Entity:

PHX Energy is a publicly-traded Corporation listed on the Toronto Stock Exchange under the symbol "PHX".

The Corporation, through its subsidiaries, provides horizontal and directional drilling services, as well as web-based remote electronic drilling recorder ("EDR") technology and services, to oil and natural gas exploration and development companies in Canada, United States, Albania, and Russia. The Corporation also develops and manufactures technologies that are made available for internal operational use.

The condensed consolidated interim financial statements include the accounts of the Corporation and its wholly owned subsidiaries.

## 2. Basis of Preparation:

### a) Statement of Compliance

These condensed consolidated interim financial statements have been prepared in accordance with IAS 34 Interim Financial Reporting. The condensed consolidated interim financial statements do not include all of the information required for full annual financial statements and should be read in conjunction with the consolidated financial statements of the Corporation as at and for the year ended December 31, 2014.

These condensed consolidated interim financial statements were authorized by the Board of Directors on November 4, 2015.

## b) Basis of Measurement

The condensed consolidated interim financial statements have been prepared on a going concern basis and use the historical cost basis except for liabilities for cash-settled share-based payment arrangements which are measured at fair value and included in trade and other payables in the statement of financial position.

## c) Functional and Presentation Currency

These condensed consolidated interim financial statements are presented in Canadian dollars, which is the Corporation's functional currency.

## d) Use of Estimates and Judgments

The preparation of the condensed consolidated interim financial statements in conformity with International Financial Reporting Standards ("IFRS") requires Management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

In preparing these condensed consolidated interim financial statements, the significant judgments made by Management in applying the Corporation's accounting policies and the key sources of estimation uncertainty have not changed significantly since December 31, 2014, except for:

- a change in the estimate relating to the residual values of drilling equipment; and
- a change in the estimates for key assumptions relating to the valuation of goodwill and intangible assets (see Notes 7 and 8).

# 3. Significant Accounting Policies:

These condensed consolidated interim financial statements have been prepared utilizing the same accounting policies and methods as the consolidated financial statements of the Corporation for the year ended December 31, 2014.

## New Standards and Interpretations Not Yet Adopted:

Certain new standards, interpretations, amendments and improvements to existing standards are effective for accounting periods beginning on after January 1, 2016. These standards have not been applied in preparing these condensed consolidated interim financial statements. Those which may be relevant to the Corporation are set out below.

## a) IFRS 9 Financial Instruments (2014)

IFRS 9, published in July 2014, replaces the existing guidance in IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 includes revised guidance on the classification and measurement of financial instruments, including a new expected credit loss model for calculating impairment on financial assets, and the new general hedge accounting requirements. It also carries forward the guidance on recognition and derecognition of financial instruments from IAS 39. IFRS 9 is effective for annual reporting periods beginning on or after January 1, 2018, with early adoption permitted. The Company intends to adopt IFRS 9 (2014) in its financial statements for the annual period beginning on January 1, 2018. The extent of the impact of adoption of the standard has not yet been determined.

## b) IFRS 15 Revenue from Contracts with Customers

IFRS 15 establishes a comprehensive framework for determining whether, how much and when revenue is recognized. It replaces existing revenue recognition guidance, including IAS 18 Revenue. IFRS 15 is effective for annual reporting periods beginning on or after January 1, 2018, with early adoption permitted. The Corporation intends to adopt IFRS 15 for the annual period beginning on January 1, 2018. The extent of the impact of adoption of the standard has not yet been determined.

# 4. Operating Segments:

The Corporation provides horizontal and directional drilling services as well as EDR services to the oil and natural gas exploration and development companies. PHX Energy's reportable segments have been aligned geographically as follows:

Information about reportable segments

*(Stated in thousands of dollars)*

| | | Canada | | United States | | International | | Total |
|---|---|---|---|---|---|---|---|---|
| Three-month periods ended September 30, | **2015** | 2014 | **2015** | 2014 | **2015** | 2014 | **2015** | 2014 |
| Revenue | **19,499** | 51,111 | **42,521** | 75,985 | **6,207** | 11,875 | **68,227** | 138,971 |
| Reportable segment profit (loss) before income taxes | **(19,880)** | 11,432 | **(1,797)** | 5,319 | **797** | 2,586 | **(20,880)** | 19,337 |

*(Stated in thousands of dollars)*

| | Canada | | United States | | International | | Total | |
|---|---|---|---|---|---|---|---|---|
| Nine-month periods ended September 30, | **2015** | 2014 | **2015** | 2014 | **2015** | 2014 | **2015** | 2014 |
| Revenue | **69,319** | 131,359 | **142,498** | 199,294 | **18,825** | 37,933 | **230,642** | 368,586 |
| Reportable segment profit (loss) before income taxes | **(29,361)** | 14,537 | **(7,754)** | 16,930 | **3,554** | 7,876 | **(33,561)** | 39,343 |

*(Stated in thousands of dollars)*

| | Canada | | United States | | International | | Total | |
|---|---|---|---|---|---|---|---|---|
| As at September 30, | **2015** | 2014 | **2015** | 2014 | **2015** | 2014 | **2015** | 2014 |
| Drilling and other equipment | **149,307** | 160,434 | **14,361** | 15,261 | **15,455** | 15,761 | **179,123** | 191,456 |
| Goodwill | **8,876** | 31,230 | **-** | - | **-** | - | **8,876** | 31,230 |

## Reconciliation of reportable segment profit and other material items

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | Nine-month periods ended September 30, | |
|---|---|---|---|---|
| | **2015** | 2014 | **2015** | 2014 |
| Reportable segment profit (loss) before income taxes | **(20,880)** | 19,337 | **(33,561)** | 39,343 |
| Corporate: | | | | |
| Selling, general and administrative expenses | **249** | 2,265 | **1,439** | 8,761 |
| Provision for settlement of litigations | **5,555** | - | **6,533** | - |
| Research and development expenses | **615** | 915 | **1,789** | 2,413 |
| Finance expense | **698** | 1,033 | **2,830** | 2,925 |
| Other income | **3,642** | (1,187) | **2,904** | (3,323) |
| Earnings (Loss) before income taxes | **(31,639)** | 16,311 | **(49,056)** | 28,567 |

# 5. Seasonality of Operations:

A significant portion of the Corporation's operations are carried out in western Canada. The ability to move heavy equipment in the Canadian oil and natural gas fields is dependent on weather conditions. As warm weather returns in the spring, the winter's frost comes out of the ground rendering many secondary roads incapable of supporting the weight of heavy equipment until they have thoroughly dried out. The duration of this "spring break-up" has a direct impact on the Corporation's activity levels. In addition, many exploration and production areas in northern Canada are accessible only in winter months when the ground is frozen enough to support equipment. The timing of freeze-up and spring break-up affects the ability to move equipment in and out of these areas. As a result, late March through May is traditionally the Corporation's least active time, and as such the operating results of the Corporation will vary on a quarterly basis.

# 6. Drilling and Other Equipment:

## a) Acquisitions and Disposals

During the nine-month period ended September 30, 2015, the Corporation acquired assets with a cost of $17.2 million (2014 - $55.8 million).

Assets with a carrying amount of $7.0 million (2014 - $6.9 million) were disposed of as a result of tools lost down hole and scrapped assets, resulting in a net loss on disposition of $3.7 million (2014 - gain of $3.9 million), which is included in other expenses in the condensed consolidated statement of comprehensive income.

## b) Capital Commitments

As at September 30, 2015, the Corporation has commitments to purchase drilling and other equipment for $0.8 million; delivery is expected to occur within the next quarter.

## c) Change in Estimate

In September, 2015, the Corporation reviewed the residual values of its drilling equipment and now expects it to be nil instead of its previous estimate of zero to 20 percent of acquisition cost. The effect of this change in the depreciation expense for the nine-month period ended September 30, 2015 is $4.8 million.

# 7. Goodwill

In the third quarter of 2015, the Corporation determined that the continuation of the industry downturn and the delay in the expected recovery of the oil prices were indicators of impairment as they would impact future activity levels. As such an impairment test was performed on the Corporation's Canadian and Stream Services ("Stream") cash-generating unit ("CGUs"). Consistent with the impairment tests performed at December 31, 2014, the recoverable amount of the CGUs were determined using calculations of value in use, which is the present value of projected future cash flows based on a five-year budget approved by Management. The cash flows used in the calculation were discounted using a pre-tax discount rate, which was estimated using the weighted average cost of capital formula and adjusted for risks specific to each CGU.

## a) Canada

A change to the key assumptions used in the estimation of the recoverable amount of the Canadian CGU was on its budgeted EBITDA for the next 5 years. Based on the assessment performed, the estimated recoverable amount of the CGU exceeded its carrying amount and there was no impairment of goodwill for this CGU as of September 30, 2015. Management has identified that an increase of 5 percent in the discount rate could cause the carrying amount of the Canadian CGU to exceed the recoverable amount.

## b) Stream

The following are the changes to the key assumptions used in the estimation of the recoverable amount of the Stream CGU:

- Estimates of revenue and EBITDA margin in the five-year business plan were reduced by approximately 50 percent.
- Pre-tax discount rate was increased to 30 percent to reflect the increased forecast risk in terms of the CGU's cash flows. Given the currently depressed state of the industry, the period of time that will be required to grow the business could take longer than expected.

Based on these changes, the carrying amount of the CGU was determined to be higher than its recoverable amount of $20.0 million and as a result, an impairment loss of $13.8 million was recognized in the nine-month period ended September 30, 2015 (2014 – nil). Of the impairment loss $7.3 was allocated to goodwill and $6.5 million was allocated to intangible assets, which are comprised of $5.8 million relating to an old version of the EDR technology and $0.7 million relating to a customer relationship. Following the impairment loss recognized in the Corporation's Stream CGU, the recoverable amount was equal to the carrying amount. Therefore, any future adverse movement in a key assumption may lead to further impairment.

# 8. Intangible Assets:

During the nine-month period ended September 30, 2015, the Corporation acquired intangible assets with a total cost of $7.9 million (2014 - $8.5 million), $5.5 million of which related to a license agreement and the remainder related mostly to development costs. An additional $5.0 million is estimated to be paid, contingent on the licensor's successful completion of performance criteria set under the license agreement.

As at September 30, 2015, the contingent liabilities arising from the agreements are as follows:

*(Stated in thousands of dollars)*

| | 2015 | 2016 | 2017 | Total |
|---|---|---|---|---|
| License | - | 1,000 | 4,000 | 5,000 |

In the nine-month period ended September 30, 2015, $6.5 million of impairment losses were recognized on intangible assets relating to the Corporation's Stream CGU (see Note 7).

# 9. Loans and Borrowings:

*(Stated in thousands of dollars)*

| | Currency | Amount of Facility | Date of Maturity | Currency | Carrying Amount at September 30, 2015 | Currency | Carrying Amount at December 31, 2014 |
|---|---|---|---|---|---|---|---|
| Operating Facility | CAD | 15,000 | Due on demand | CAD | **303** | CAD | 5,503 |
| Syndicated Facility [1] | CAD | 90,000 | December 12, 2018 | CAD | **70,000** | CAD | 95,000 |
| US Operating Facility [1] | USD | 2,500 | December 12, 2018 | USD | **-** | USD | 8,000 |

[1] *Amounts of facilities reflect reductions based on amendments that were effective October 16, 2015.*

On October 16, 2015, the Corporation amended its credit agreement with its syndicate of lenders. The key amendments reflected the following revisions to PHX Energy's financial and negative covenants under its credit facilities:

- The ratio of Debt to covenant EBITDA shall not exceed 5.0x for the quarters ending December 31, 2015, March 31, 2016, June 30, 2016 and September 30, 2016, shall not exceed 4.0x for the quarter ending December 31, 2016 and shall not exceed 3.0x for the quarter ending March 31, 2017, all calculated on a four quarter rolling basis;

- For the purposes of the calculation of the covenant EBITDA during the period from the quarter ended March 31, 2015 to the quarter ending March 31, 2016, PHX Energy shall be permitted to add back actual severance costs paid up to a maximum of CDN$5.0 million and settlement amounts to be paid (and provisions made in respect thereof) by the Corporation in respect of the US litigations (see Note 10) to a maximum aggregate of CDN$6.5 million;

- The Corporation's negative covenant, which limits its annual dividends based on the amount of its yearly distributable cash flow, shall not apply to the financial year ending December 31, 2015. Distributable cash flow is defined under the credit agreement as covenant EBITDA for the year less maintenance capital expenditure, scheduled principal repayment of debt, interest expense paid, and income taxes paid. In addition, during the covenant relief period through to December 31, 2016, there will be no increases permitted in the rate of dividends payable by the Corporation.

- The maximum principal amounts available to the Corporation under each of the Syndicated Credit Facility and the US Operating Facility were reduced from CDN$160 million to CDN$90 million and US$25 million to US$2.5 million, respectively. The purpose of the decrease is to reduce the standby fees charged on unused balances under the credit facilities.

In accordance with the amendments, effective September 30, 2015, EBITDA under the credit agreement (referred above and below as "covenant EBITDA"), was calculated as net earnings for a rolling four quarter period, adjusted for finance expense, provision for income taxes, depreciation and amortization, equity-settled share-based payments, unrealized foreign exchange losses, impairment losses on goodwill and intangible assets, loss on disposition of drilling equipment, severance costs, and provision for the settlement of litigations, subject to the restrictions provided in the amended credit agreement.

As at September 30, 2015, the Corporation was in compliance with all its financial covenants as follows:

| Ratio | Covenant | **As at September 30, 2015** |
|---|---|---|
| Debt to covenant EBITDA | < or = 3.00:1.00 | **1.54** |
| Interest coverage ratio | > or = 3.00:1.00 | **11.06** |

Based on the reduced amounts of the credit facilities, the Corporation had approximately CAD$34.7 million and US$2.5 million available to be drawn from its credit facilities as at September 30, 2015.

# 10. Provisions:

a) As previously announced, the Corporation's wholly-owned subsidiary, Phoenix Technology Services USA Inc. ("Phoenix USA"), had been named in a collective legal action in Houston, Texas. The claimants alleged that they were improperly classified as exempt under the Fair Labour Standards Act and therefore entitled to unpaid overtime.

b) On February 20, 2015, Phoenix USA was named in a second collective legal action in Houston, Texas commenced by two former consultants and joined by one consultant (the "Claimants"), alleging that they were improperly classified as independent contractors (as opposed to employees) under the Fair Labor Standards Act and are entitled to unpaid overtime.

c) On May 29, 2015, Phoenix USA was named in a class legal action in Pittsburgh, Pennsylvania commenced by a former employee claiming that he was improperly classified as exempt under the Pennsylvania Minimum Wage Act ("PMWA") and therefore entitled to unpaid overtime. In this complaint, it was alleged that improper classification was imposed on similarly situated individuals (PMWA class members).

In September, 2015, Phoenix USA and the parties to the collective and class actions above have entered into a settlement agreement wherein the parties have agreed for the full and final release and dismissal of all claims and allegations made in the collective and class actions, by the establishment of a US$5.0 million settlement fund, which shall be funded by the Corporation in three equal instalments on November 2, 2015, January 1, 2016 and January 31, 2016. The settlement agreement includes all MWD operators employed by Phoenix USA, regardless of the states in which they worked and whether they had already joined one of the pending lawsuits. In October, 2015, the Corporation received the requisite court approval of the settlement agreement. During the nine-month period ended September 30, 2015, PHX Energy recognized a provision of $6.5 million for the settlement.

# 11. Share Capital:

## a) Authorized and Issued Shares

The Corporation is authorized to issue an unlimited number of shares.

| | Number | | Amount |
|---|---|---|---|
| Balance as at January 1, 2014 | 34,218,974 | $ | 165,451,599 |
| Issued shares pursuant to share option plan | 774,302 | | 10,289,836 |
| Issued shares pursuant to DRIP | 244,563 | | 2,908,905 |
| Balance as at December 31, 2014 | 35,237,839 | $ | 178,650,340 |
| | | | |
| Issued shares pursuant to DRIP | **136,188** | | **825,707** |
| Issued shares pursuant to equity financing and private placement | **6,191,700** | | **35,602,275** |
| Transaction costs | | | **(2,116,639)** |
| Tax effect of transaction costs | | | **591,329** |
| Balance as at September 30, 2015 | **41,565,727** | **$** | **213,553,012** |

On June 30, 2015, PHX Energy closed a bought deal financing for aggregate proceeds of $35.0 million. An aggregate of 6,095,000 common shares of the Corporation were issued at a price of $5.75 per common share. Concurrent with the closing of the public offering, certain directors and officers of PHX Energy and their associates purchased a total of 96,700 common shares at a price of $5.75 per share on a private placement basis. The gross proceeds from the public offering and concurrent private placement totaled to approximately $35.6 million.

## b) Dividends

During the nine-month period ended September 30, 2015, the Corporation paid monthly dividends totaling $12.7 million (2014 - $21.8 million).

On February 25, 2015, the Board of Directors (the "Board") approved a 50 percent reduction in dividends from $0.07 per share per month to $0.035 per share per month which became effective for the March dividend. On May 6, 2015, the Board approved a further 50 percent reduction to its dividend from $0.035 per share per month to $0.0175 per share per month which became effective for the Corporation's May dividend.

In light of current and forecasted industry conditions, on September 10, 2015, the Board approved a reduction to PHX Energy's monthly dividend from $0.0175 per share per month to $0.0033 per share per month effective for the September dividend. Subsequent to the September dividend, the Corporation will commence to pay a quarterly dividend of $0.01 per share effective for the fourth quarter of 2015, payable on January 15, 2016.

On September 15, 2015, PHX Energy declared a dividend of $0.0033 per share or $0.1 million, payable on October 15, 2015. In aggregate, dividends of $10.4 million (2014 - $22.0 million) were declared for the nine-month period ended September 30, 2015.

# 12. Other Expenses (Income):

*(Stated in thousands of dollars)*

| | Three-month periods ended September 30, | | Nine-month periods ended September 30, | |
|---|---|---|---|---|
| | **2015** | 2014 | **2015** | 2014 |
| Loss (Gain) on disposition of drilling equipment | **4,280** | (607) | **3,673** | (3,870) |
| Foreign exchange losses (gains) | **(638)** | (858) | **(807)** | (466) |
| Provision for bad debts | **-** | 278 | **38** | 1,013 |
| Other Expenses (Income) | **3,642** | (1,187) | **2,904** | (3,323) |

# 13. Income Taxes:

The Government of Alberta increased the corporate income tax rate from 10 percent to 12 percent, resulting in a blended corporate tax rate of 11 percent for the year ended December 31, 2015. This was substantively enacted in June, 2015.

# 14. Fair Values of Financial Instruments:

The Corporation has designated its trade and other payables and dividends payable as other financial liabilities carried at amortized cost. Trade and other receivables are designated as loans and receivables, measured at amortized cost. The Corporation's carrying values of these items approximate their fair value due to the relatively short periods to maturity of the instruments. Loans and borrowings have been designated as other financial liability, and are measured at amortized cost. The fair value of loans and borrowings included in the condensed consolidated statement of financial position approximates fair values as the indebtedness is subject to floating rates of interest.

# corporate information

## Board of Directors

John Hooks

Randolph ("Randy") M. Charron

J. Cameron Bailey

Myron Tétreault

Judith Athaide

Lawrence Hibbard

Roger Thomas

## Officers

John Hooks
*CEO*

Michael Buker
*President*

Cameron Ritchie
*Sr. Vice President Finance and CFO*
*Corporate Secretary*

Craig Brown
*Sr. Vice President International Operations and Technology*

Daniel Blanchard
*Vice President Executive Sales*

Jeffery Shafer
*Vice President Sales and Marketing*

Quinten Bertelsen
*Vice President Operations*

## Legal Counsel

Burnet, Duckworth & Palmer LLP
Calgary, Alberta

## Auditors

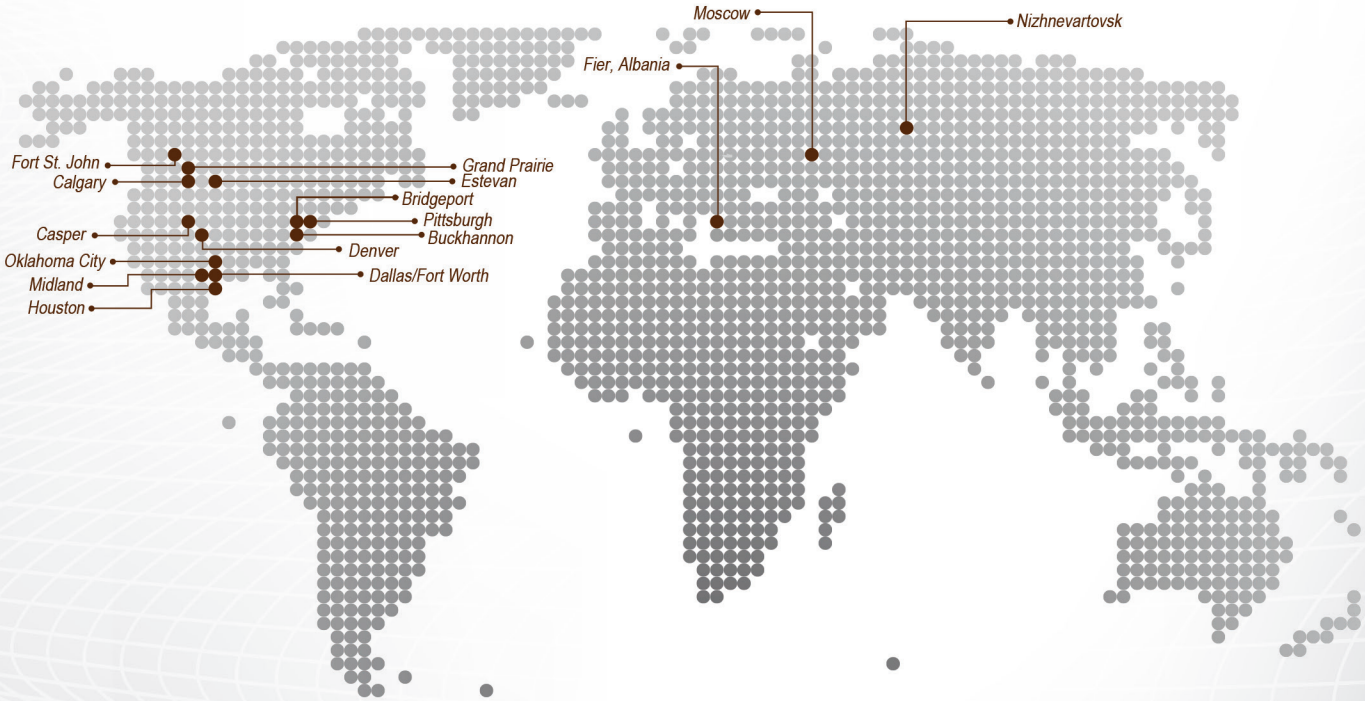
KPMG LLP
Calgary, Alberta

## Bankers

HSBC Bank Canada
Calgary, Alberta

## Transfer Agent

Computershare Trust Company of Canada
Calgary, Alberta

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