Annual Report

The Goodwood Fund
1996 Annual Report

To the Unitholders of The Goodwood Fund:

The Goodwood Fund's ("the Fund") December 31, 1996 Net Asset Value ("NAV") stood at **$9.47**, a decrease of **0.94%** versus the October 31, 1996 initial NAV of **$9.56**. As of March 31, 1997 the NAV stood at $9.67, resulting in a rise of **1.15%** since October 31, 1996. Our year-to-date rate of return (as of March 31, 1997) amounts to **2.11%**.

Since October 31st, 1996 the TSE 300 Total Return Index ("TRIN")(the TSE 300 Stock Index with dividends reinvested) has risen from a level of **11,350.62** to a level of **12,061.95** as at December 31, 1996 (an increase of **6.27%**) and a level of **11,961.20** as at March 31, 1997 (an increase of **5.38%** since October 31, 1996). For the year-to-date (as of March 31, 1997), the TRIN has declined by **0.84%**.

No capital gains or income distributions were made in 1996.

The Fund's portfolio as at December 31, 1996 and as at March 31, 1997 are attached for your review. As well a copy of the Fund's 1996 audited financial statements are attached.

Portfolio Review:

Our portfolio is geared towards long term investment not short term trading. Thus, there will be periods during which the bulk of the portfolio is relatively static.

The Fund's investments are in securities that I perceive to be priced substantially below "inherent business value". Eventually, I expect that these securities will be priced more closely to their inherent business value, although the timing and certainty of such cannot be predicted. In some cases, the "value" is in a share price below the calculated net asset value underlying each share. In other cases, the "value" is in a price-to-earnings multiple below the earnings growth rate. Of course, in practice, there are a myriad of situations that don't fall neatly into one camp or the other.

When combined with improving fundamentals, a value situation is the equivalent of investment "nirvana" for the Fund.

Theme Investing?:

There really is only one "theme" running through our portfolio. Briefly put, the proliferation of the number of video channels and the number of methods of delivering these extra channels (satellite TV, micro-wave TV, etc.) will be beneficial for "content providers" (a company that generates programming that can be aired on one of these channels). Alliance Communications Corporation (film/TV production and distribution, and specialty channels), Astral Communications Inc. (pay TV, pay-per-view TV and specialty channels), King World Productions, Inc. (TV show production and distribution) and Rainmaker Digital Pictures Corp. (post production work for TV and film, digital video compression technology) in one way or another are all potential beneficiaries of this trend.

Collectively, as at March 31, 1997, these positions accounted for **22.9%** of our total portfolio.

Most Significant Positions: As of March 31, 1997, our five most significant positions account for approximately **45.8%** of the Fund's net assets.

Astral Communications Inc. ("Astral") class "A":

- **Renewed focus on the good businesses:** Astral's recent divestitures of their Retail Photographic Division, their Film Distribution and Program Development Division and, their CD manufacturing plant in Florida bodes well for the future profitability of the Company as a whole. On balance these businesses were either losing money or making very little (representing a poor use of capital). Management will now be focusing their capital and attention on the remaining Braoadcast (the largest pay, pay-per-view, and specialty channel operator in Canada), Videocassette Wholesaling, Technical Services and Content Creation divisions all of which feature strong economics.
- **Balance Sheet Strengthened:** Post divestitures, Astral is left with approximately $20 million of cash against only $2.4 million of long term debt.
- **New Video Delivery Technologies = More Subscribers:** Astral's package of broadcast services (e.g., Family Channel, The Movie Network, Canal D, etc.) is in demand by the new Canadian satellite operators as an important component of their channel offerings. Agreements have already been entered into with EspressVue and Star Choice/Home Choice. This should drive some incremental growth in Astral's subscriber base.
- **Digital Set-Top Boxes = More Subscribers:** The cable companies are in the process of installing digital set-top boxes across their systems as a step in delivering more channels, better picture quality and interactivity to their subscribers. Astral will benefit through its existing arrangements with Canada's major cable operators because digital boxes eliminate piracy (you can't steal a digital signal) and allow for multiple channel distribution of pay-per-view programming. If Astral's Montreal experience is repeated, a 35% to 40% portion of the estimated pirate population should become subscribers when they can no longer get the service for free.
- **Inexpensive Valuation:** A couple of years of disappointment have led to an inexpensive valuation being placed on Astral's shares. Based on fiscal 1997 (August 31 fiscal year end) forecast EBITDA of $39 million and a current share price of $14.90, Astral enterprise value is being priced at only 4.6X EBITDA. Viacom, Inc., in comparison is valued at 10.3X EBITDA and has considerable financial leverage (Viacom operates The Movie Channel, Showtime, Nickelodeon, MTV & VH1 channels). With reported earnings and cash flow on the upswing ($0.14 in EPS in Q1 F1997 versus $0.09 in Q1 of F1996) investor attention and confidence should gradually return.

Average Cost: $14.25 per share **Target Price:** $22 to $24 per share

Silcorp Limited ("Silcorp") common:

- **Shareholder-Friendly Actions:** Under presuure to convince their shareholders to not accept an unfriendly takeover offer Silcopr management reacted by; a. finalizing long-running discussions to purchase their single major competitor in the Ontario market, The Becker Milk Company ("Beckers"), sell their non-core U.S. operations for U.S.$21.3 million and. c. use the proceeds from the sale of non-core assets to finance the repurchase and cancellation of 885,000 Silcorp common shares at $19 per share (the tender was actually for 1.26 million shares but the full amount was not tendered).
- **The Beckers Synergies:** The Beckers acquisition should deliver substantial synergies consisting of the following: overhead cost reductions ($3.5 million in fiscal 1997 and $5.5 million in fiscal 1998), improvements in Beckers' dairy plant capacity utilization rate (i.e., by selling Beckers milk products across the Silcorp stores)($0.2 and $1.5 million respectively), improvements in product margins (e.g., getting larger discounts from suppliers)(1.9 and $3.0 million respectively) and, improvements in store productivity (e.g., close competing and non-productive stores)($2.7 and $3.0 million respectively).
- **Large Gains in Earnings Expected:** As a result of the above synergies, Silcorp's EBIT should ramp up from approximately $9 million in fiscal 1996 to $19.1 million in fiscal 1998. Earnings per share should grow from $2.05 in fiscal 1996 to more than $4.00 in fiscal 1998 (note that, due to approximately $55 million in tax loss carryforwards, earnings should not be taxable for several years).

Average Cost: $20.97 per share **Target Price:** $32.00 to $35.00 per share

The Molson Companies Limited ("Molsons") class "A":

- **Sale of Chemical Specialties Division:** Molsons decision to sell the money-losing Diversy Corporation (and related businesses) was good news for the shareholders. It marked the Board's commitment to return to Molsons core operations and generated substantial excess cash. As of December 31, 1996 Molsons had $723.5 million of cash which, when combined with the $62.3 million received from the recent sale of Reno-Depot Inc., leaves cash of $13.43 per share (versus current stock price of $23). Furthermore, Molsons core operations generate good returns on capital.
- **Balance of Retailing Interests to Be Sold:** The remaining non-core assets are 25% of The Home Depot Canada and 100% of Beaver Lumber Company. Molsons has indicated that these assets are to be sold. Estimates of the value of these businesses are generally $300 million plus ($5.13 per share).

- **The Molson Breweries Partnership ("Partnership"):** Molsons appears to be intent on buying back some or all of the Partnership (Fosters Brewing Group Ltd. of Australia and Miller Brewing Co. of the U.S. own 40% and 20% respectively while Molsons owns the other 40%). This would be a good use of Molsons excess cash as the Partnership continues to generate above average returns (fiscal 1996 return on capital invested 27.3%). The much-discussed Coors arbitration setback is a non-issue. At worst, it will result in a slightly less generous profit sharing arrangement for the Partnership.
- **Investor Disenchantment = Inexpensive Valuation:** The investment community's deserved disappointment with Molsons' recent corporate performance has resulted in a cheap stock price. At some point, conceivably 81% of the current stock price could be represented by cash (assuming the sale of the remaing retailing interets). Thus, the valuation being placed on the remaining businesses would be only $4.30 per share (or $251.5 million) for two businesses (40% of the Partnership and 100% of the Montreal Canadiens/Molson Centre (the Molson Centre was completed last year for $267 million)) that currently generate approximately $108 million in pre-tax earnings.

Average Cost: $21.91 per share **Target Price:** $30 to $32 per share

Yogen Fruz World-Wide Inc. ("Yogen Fruz") common:

- **Strong Earnings Growth:** Yogen Fruz is trading at a substantial Price/Earnings multiple discount relative to its likely growth rate. Net earnings have risen from $0.7 million ($0.04 per share) in fiscal 1994 (August 31 fiscal year end) to $1.8 million ($0.12) in fiscal 1995 and $5.2 million ($0.24) in fiscal 1996. While not followed widely, the analysts who do follow Yogen Fruz are generally predicting between $0.29 and $0.32 in EPS in fiscal 1997 and bewteen $0.39 and $0.42 for fiscal 1998. Fiscal 1997 second quarter earnings came in at $1.3 million ($0.05 per share) versus $0.5 million ($0.03) in the year ago period.
- **Earnings Growth Rate Exceeds PE Multiple:** With earnings growing at approximately 30% per annum for at least the next two years (and the last two years' growth rate standing at 41% per annum), Yogen Fruz deserves a greater multiple than 12.6X (calculated on our cost base) this year's earnings. Further positive earnings reports should improve the PE multiple.
- Entrepreneurial Management Team with Large Shareholding:

Astral is Canada's leading broadcaster of English and French pay-per-view, pay and specialty television services (Various interests include: Canal D, Canal Famille, MOVIEPIX, The Movie Network, Super Ecran, Family Channel, Viewer's Choice, Viewer's Choice - DTH, Canal Indigo, Canal Indigo - DTH, TELETOON, The Comedy Network). As well, it is the largest wholesaler of videocassettes in the country, operates a technical services division (providing videocassette duplication, motion picture film developing and release printing, etc.) and, has interests in a family animation programming company and a games and multimedia software company.

Renewed focus on the good businesses: Astral's' recent divestitures of their Retail Photographic Division ("Astral Photo"), their film distribution and program development division and, their CD manufacturing plant in Florida ("AstralTech Americas") bodes well for the future profitability of the Company as a whole. On balance these discarded businesses were either losing money or making very little (representing a poor use of capital for Astral).

Post divestitures, Astral is left with approximately $20 million of cash on hand against long term debt of only $2.4 million. Furthermore, management's attention is now focused squarely on core businesses that have far better economics. I consider Astral's Broadcast Division to be a rare find in that it is regulated (and as such the Canadian Radio and Telecommunications Commission ("CRTC") limits the amount of Canadian competition that Astral will face) and yet its profits are not regulated.

In fiscal 1996 (Astral's fiscal year end is August 31), Astrals' Broadcast Division showed pre-tax income of $13.4 million on sales of $109.7 million. This represents a 12.2% return on sales and a 17.7% return on capital employed in the Broadcast Division (net of the carrying value of broadcast licenses). Note that results for fiscal 1996 were depressed by a multi-year provision for royalties for which the Company may become liable to the Society of Composers, Authors and Music Publishers of Canada (comparative figures for fiscal 1995 were: 15.3% and 23% respectively).

The Entertainment Division's (comprised of the Videocassette Wholesaling, Technical Services and Content Creation divisions) pre-tax income margin was 6.8% and 5.7% in fiscal 1996 and fiscal 1995 respectively.

New Video Delivery Technologies + New Services = More Subscribers & Higher Cash Flow/Earnings: Astral is in the enviable position of being able to sell its broadcasting services through cable operators, satellite operators or any other future video delivery method. The cable and satellite companies are keen to offer their current and prospective subscribers the best Canadianized "content" package that they possibly can. Without a doubt, Astral is a partner that they wish to enter into business with since Astral can offer so many services from under one roof. In addition to having long-standing business arrangements with Rogers Cable and Shaw Cable, Astral has already been retained by ExpressVue and StarChoice, two of Canada's new DTH ("Direct-to-Home") satellite operators.

Digital Set-Top Boxes: The cable companies' response to the satellite threat has been focused on beefing up their ability to deliver more channels, better picture quality and, interactivity. One of the key building blocks of this strategy is the introduction of the digital set-top box. Importantly, the digital box allows multiple channel distribution of pay-per-view programming through cable eliminates "piracy" of pay TV and pay-per-view network services.

In some markets, piracy is estimated to account for 50% or more of the total estimated viewing population. The introduction of digital boxes in Montreal by Videotron Inc. has resulted in a noticeable increase in the number of subscribers to Astral's French language offerings suggesting that some portion of the pirate population become subscribers when they can no longer steal the signal.

Another important positive concerning the introduction of digital boxes is that the cost of the set-top decoder will no longer be borne exclusively by pay TV services but rather by all television services, thereby lowering the effective price barrier for those who wish to become subscribers to Astral's pay services.

The phased-in introduction of digital set-top boxes by the cable companies over the next three years is very good news for Astral.

As well, Astral's subscriber base should go up as it is able to introduce more channels. Fiscal 1997 will see the launching of two new networks; TELETOON (will be available in both French and English) and The Comedy Network (initially available only in English).

Inexpensive Valuation: Based on an Enterprise Value/EBITDA valuation approach, Astral shares are cheap (enterprise value is the market value of a company's stock plus its debt minus working capital; EBITDA stands for earnings before interest, taxes, depreciation and amortization). Enterprise Value/EBITDA allows us to compare the market's valuation of two or more companies in the same industries while taking into account their debt positions.

Based on my forecast of $39 million in EBITDA in fiscal 1997 and a current share price of $14.90, Astral is currently valued at 4.6X EBITDA versus a 10.3X multiple for Viacom, Inc. (Viacom operates the Showtime, The Movie Channel, Nickelodeon, MTV & VH1 channels)

I believe that Astral is underfollowed (due to a couple of years of disappointing results) and thus undervalued. With reported earnings and cash flow figures on the upswing (net earnings per share of $0.14 were reported for the quarter ended November 30, 1996 versus $0.09 for the year ago period) investor attention and confidence should gradually return.

Average Cost: $14.25 per share **Target:** $22 to $24 per share

Silcorp Limited ("Silcorp") common:

Silcorp is one of the largest convenience store operators in Canada with over 1,030 stores, mostly in Ontario, representing approximately 40% of the Ontario convenience store market. The Fund's purchases of Silcorp have been driven by an unusual set of circumstances in the Company's recent corporate history.

An unfriendly takeover offer valued at $16.50 per share by a Quebec competitor, Alimentation Couche-Tard Inc. ("Couche-Tard"), unleashed a series of events that have resulted in Silcorp being in a position to deliver substantially better shareholder values going forward.

Shareholder-Friendly Actions: Under pressure to convince their shareholders that they should not accept the Couche-Tard bid, Silcorp management reacted by; a. finalizing long-running discussions to purchase their major Ontario competitor, The Becker Milk Company ("Beckers") on very favorable terms (purchased for $13.5 million cash, a $4 million note and 1,000,000 Silcorp common shares = approximate price of $35.5 million), b. sell its non-core 51-store Michigan "Hop in" gas bar/convenience store chain (for proceeds of US$21.3 million) and c. use the proceeds from the Michigan operations' sale to finance the repurchase and cancellation of 1.26 million Silcorp common shares at $19 per share (there were 5.16 million shares outstanding before the buyback).

Beckers Synergies: The Beckers acquisition will likely deliver substantial operational "synergies". While I'm not normally a fan of any management team's ability to deliver synergies, I think in this case the simplicity of the business, the low purchase price of the acquisition (featuring a significant portion of the purchase price paid in Silcorp stock) and, the track record of successful operations of the acquiring management team weigh in favor of accepting the synergies argument.

Specifically, management's forecast of the benefits that merging Beckers and Silcorp's operations should deliver are as follows; overhead cost reductions (estimated at $3.5 and $5.5 million in fiscal 1997 and fiscal 1998 respectively), improvements in Beckers' dairy operations' capacity utilization (by selling Beckers milk products in the Silcorp stores)(estimated at $0.2 and $1.5 million respectively), improvements in product margins (i.e., getting larger discounts from suppliers)(estimated at $1.9 and $3.0 million respectively) and, improvements in store productivity (e.g., close competing and non-productive stores)(estimated at $2.7 and $3.0 million respectively).

Large Gain in Earnings Expected: These synergies are expected to total $8.3 million in fiscal 1997 and $13.0 million in fiscal 1998. Thus, EBIT (earnings before interest and taxes) should ramp-up from approximately $9 million in fiscal 1996 to approximately $19.1 million in fiscal 1998. Having purchased and canceled 885,000 shares (shareholders did not tender fully to the 1.26 million share repurchase offer) on February 20, 1997, Silcorp is now in a position to generate more than $4.00 per share in earnings in fiscal 1998 (note that the earnings will not be taxable for several years given approximately $55 million of tax loss carryforwards). Earnings in fiscal 1996 were only $2.05 per share.

Management is wholly-focused on increasing shareholder value (this is all the more so since management convinced shareholders to reject the Couch-Tard bid) and given their strong performance over the last few years (post the restructuring of 1992), I think its reasonable to have some confidence in management's projections. In addition, there are other exciting acquisition opportunities for Silcorp after Beckers has been integrated.

As an added positive, the Beckers acquisition should be just the beginning as Silcorp management will be actively pursuing other acquisiton candidates once Beckers is integrated.

Average Cost: $20.97 **Target Price:** $32.00 to $35.00 per share

The Molson Companies Limited ("Molsons") class "A":

Molsons controls 40% of Molson Breweries Partnership, 100% of Beaver Lumber Company, 100% of the Club de Hockey Canadien, 100% of the Molson Centre and has a 25% partnership interest in The Home Depot Canada.

The Decision to Sell the Chemical Specialties Business: The catalyst for our initial research into Molsons was the long-overdue decision by management and the Board of Directors to sell their Diversy Corporation (and related businesses) interest. Once completed, the sales resulted in Molsons having $723.5 million of cash as of December 31, 1996 which, when combined with the $62.3 million of proceeds from the subsequent sale of Molsons' 45.1% interest in Reno-Depot, leaves Molsons' with $785.5 million of cash (roughly $13.43 per share versus a stock price that currently sits at approximately $23). Note that Molsons still has $551.4 million of total debt outstanding as of December 31, 1996 (although $166.9 million of this debt relate to a construction loan and a land lease obligation related to the Molson Centre).

Importantly, the decision to sell indicated a change in attitude at the Board level that would eventually serve the outside shareholders well (i.e., sell the non-core, loss-producing assets freeing capital and management attention to focus on the good, core businesses).

The Intention to Sell the Balance of the Retailing Interests: Furthermore, Molsons appears intent on eventually selling its remaining retailing interests, 25% of The Home Depot Canada and 100% of Beaver Lumber Company (earlier this year Molsons displyaed its determination to refocus when it sold its 45.1% interest in the Quebec hardware retailer, Reno-Depot).

In the event that Molsons does sell its remaining retailing interests, additional proceeds of $300 plus million could be generated (roughly $5.13 per share).

Likely Redeployment of Free Capital back into Molson Breweries Partnership ("Partnership"): In terms of impact on stock price, clearly we need to see Molsons redirect that capital back into a business that, a. management understands and where Molsons has competitive strength and b. a business that makes a good return on investment. The Molson Breweries Partnership fits the bill.

The Partnership continues to generate above average returns on invested capital despite the volume slippage that regularly erodes their market share in Canada (estimated fiscal 1996 Canadian market share was 46.6% versus 47.2% in fiscal 1995). In fiscal 1996 (Molsons' fiscal year end is March 31 so we are yet to receive the results for fiscal 1997) Molsons' share of the Partnership's operating profit (after depreciation and amortization but before restructuring charges) was $98.9 million versus $362.8 million of average capital employed in the business during fiscal 1996 (just Molsons' share of capital employed). Thus, the Partnership generated a 27.3% return on capital in fiscal 1996.

According to the nine month results ending December 31, 1996, the Partnership continues to generate good returns. Segment operating profit for this period was $98.3 million versus $94.7 million in the comparable period of fiscal 1996.

These results should improve going forward as the Partnership is actively reducing operating costs through new labour contracts and plant capacity reduction and consolidation.

It now appears that Molsons is actively talking to their partners Fosters Brewing Group Ltd. of Australia (which owns 40% of the Molson Breweries Partnership) and Miller Brewing Co. of the U.S. (20%) about buying back some or all of the Partnership. I believe that this would be, both in reality and in perception, a solid use of capital. However, if we get lucky we'll also see a special dividend or a partial stock buyback.

The much-discussed Coors arbitration setback is a non-issue. At worst, I believe that it will result in a slightly less generous sharing arrangement for Molsons.

Investor Disenchantment = Inexpensive Valuation: The Street's deserved disappointment with Molsons' recent performance has resulted in a cheap stock price. At some point, conceivably 81% of the current stock price could be represented by cash (assuming Molsons were to sell its Home Depot and Beaver Lumber positions) and therefore one would be paying only $4.30 per share (or $251.5 million) for two businesses (the beer business and the Montreal Canadiens/Molson Centre) that are currently generating approximately $108 million in pre-tax earnings.

Average Cost: $21.91 per share **Target Price:** $30 to $32 per share

Yogen Fruz World-Wide Inc. ("Yogen Fruz") common:

Yogen Fruz is the world's largest franchisor of frozen yogurt outlets and operates a family of brands, including; Yogen Fruz, Bresler's Ice Cream, I Can't Believe It's Yogurt and Java Coast Fine Coffees. As of November 30, 1996, the Company operated over 2,923 outlets in 74 countries.

Growth Rate of Earnings Exceeds PE Multiple: Yogen Fruz is trading at a substantial Price/Earnings multiple discount relative to its likely growth rate. Net earnings have risen from $0.7 million ($.04 per share) in fiscal 1994 (fiscal year end is August 31) to $1.8 million ($0.12) in fiscal 1995 and $5.2 million ($0.24) in fiscal 1996. While not followed widely yet, the analysts who do follow Yogen Fruz, are generally predicting between $0.27 and $0.32 in earnings per share in fiscal 1997 and between $0.34 and $0.42 for fiscal 1998. Fiscal 1997 second quarter earnings came in at $1.3 million ($0.05 per share) versus $0.5 million ($0.03) in the year ago period.

If Yogen Fruz achieves, say $0.38 in earnings per share in fiscal 1998 (note that we are only five months away from the beginning of fiscal 1998), the stock should receive at least a 20X PE multiple. Clearly, the risk is whether or not the forecast earnings can be achieved. But this is a risk that declines with every quarterly report featuring good growth in earnings per share.

Entrepreneurial Management Team with Large Shareholding: Yogen Fruz's top three executives are the founders of the Company and together control approximately 30% of the shares outstanding (note the absence of any subordinate voting/multiple voting or non-voting/voting share structures in Yogen Fruz - a definite plus for the outside shareholders in the event that Yogen Fruz attracts corporate acquisition interest).

Management pay took a large jump in fiscal 1996 as Michael Serruya's pay rose from $27,140 to $157,692. However, as the Chairman, President & Chief Executive Officer of a public company with $46 million of corporate sales estimated for fiscal 1997 ($600 million plus of system-wide sales in fiscal 1997), this seems more than reasonable.

Financing Growth with Equity not Debt: Growth will be financed with equity as opposed to debt, lessening our upside somewhat (as a result of the implicit dilution) but substantially lessening the Company's financial risk. Yogen Fruz's balance sheet is currently debt-free and carries approximately $27 million cash ($0.84 per share).

New Business Endeavors are Promising: In addition to franchising frozen yogurt outlets at a rapid pace, Yogen Fruz is entering into "co-branding" agreements and opportunistically entering the institutional market.

Co-branding allows Yogen Fruz to operate a desert stand or counter in a partner's location dramatically expanding the marketing exposure of Yogen Fruz's brands. An agreement is already in place with Country Style restaurants while new deals are underway with the Subway, Mrs. Field's Cookies, Pizza Pizza, Burger King, Hardees and Kentucky Fried Chicken chains.

Yogen Fruz also has growth opportunities in the institutional market (i.e., supplying supermarket chains). In August of last year the Company signed a deal to manufacture a "hard pack" frozen yogurt product for distribution through Great Pacific Food Holdings Inc. Great Pacific's "Honey Hill Farms" is a leading Californian supermarket brand. This business has tremendous potential given the size of the markets.

Market Capitalization Increase + Research Coverage = Wider Following & Higher Multiple: As Yogen Fruz continues to grow (financing itself with the occasional share issue) and as its market capitalization increases, the company will be attracting a larger and larger institutional shareholding base. This should lead to a higher valuation being placed on earnings than is currently the case.

Average Cost: $3.80 per share **Target Price:** $7.00 to $7.50 per share

DY 4 Systems Inc. ("DYF") common:

DYF is a Canadian based company which specializes in the design and manufacture of VME (Versa Modula Europa) open architecture computer systems. These systems are used throughout the world in applications that require high reliability when operating in rugged or harsh environments (extremes of shock, vibration, heat, cold, dust and moisture). Primary applications for the Company's systems include defense, surveillance, space and aerospace. DYF is the world's largest independent producer of VME computer systems in this market niche. Virtually all of the Company's revenues are derived from sales to customers outside of Canada.

Balance Sheet is Strong: As at December 27, 1996, the Company had $39.2 million ($3.17 per share) of cash and negotiable securities on hand. Working capital stood at $49.6 million and the only long term liability was a $0.9 million lease obligation.

Stock is Inexpensive: Having declined from a high of $16.50 in February of 1996 to its current level of $8.10, DYF is now trading at a valuation of only $61.2 million (subtracting the net cash).

True, the rate of growth of sales has gone from strongly upward to mildly negative, gross margins have declined, and thus earnings have declined (from $0.75 in fiscal 1995 to $0.47 in fiscal 1996), but this trend should be temporary in nature.

"Design Wins" + Industry Trends = Future Growth: What gives me some confidence that sales and earnings growth will eventually resume is the Company's continued ability to generate "design wins" (design wins signify future business - there is usually a three to four year lag between winning a design and actually producing the design). In fiscal 1990 design wins stood at only 7 and DYF's revenue in that year was $24.0 million. By fiscal 1996 design wins reached 64 and sales were $52 million. While there is not a direct linear correlation between design wins and future revenue, there is a strong positive relationship.

Underlying the design wins indicator are some favorable industry trends; i. the U.S. Department of Defense budgets are set to increase in each of the next four years (in contrast to recent history which has seen declining budgets), ii. industry analysts predict that the military and aerospace markets are likely to command a greater share of the overall VME market (one study estimates that their share will grow from 24% in 1996 to 36% by 1999), iii. the customers' movement towards "COTS" (Commercial Off-The-Shelf) benefits DYF as it is a leader in providing COTS solutions for mission-critical applications, iv. the trend towards outsourcing (whereby a customer downloads more and more of their historically in-house activities to DYF) and, v. in 1998 DYF will enjoy several key programs entering the production phase.

Management Team has Good Track Record: The present management team was responsible for the substantial growth achieved by DYF between 1990 and 1996. To their credit they had been consistently warning their shareholders that defense budget cutbacks in the U.S. would have negative effects on their business in the short run (1996/1997).

Share Buyback Program = Stock Price Support: To support the share price DYF management have announced a share buyback program. Unlike many share buyback programs I believe that this one will actually be activated given the cheap stock price, the Company's healthy cash position and shareholder-friendly management.

Average Cost: $9.32 per share **Target Price:** $14 to $16 per share

Please call if you have any questions, thoughts or comments.

Peter Puccetti, CFA
Chairman & Chief Investment Officer