Annual Report

The Goodwood Fund
1997 Annual Report

To the Unitholders of The Goodwood Fund:

For the year ending December 31, 1997, **The Goodwood Fund** (the "Fund") returned **41.1%** (or **48.7%** before accrued performance fee). The TSE 300 Total Return Index ("TRIN") returned **15.0%** in the same period.

From October 31, 1996 (the commencement of the Fund's public operations) through to December 31, 1997, the Fund has returned **39.8%** (or **47.3%** before accrued performance fee) versus the TRIN's return of **22.2%**. *

In 1997, net capital gains, dividends and interest income (net of the management, operating and performance fees paid in 1997) amounted to **$4.39** per unit. This amount was distributed to unitholders and automatically reinvested in additional units on your behalf on December 31, 1997. As a result of this distribution, the Fund's net asset value ("NAV") per unit dropped from **$13.36** to **$8.97**. The reinvestment was made at the post-distribution NAV of **$8.97** per unit.

The Fund's 1997 audited financial statements and a copy of the Fund's portfolio as of March 31, 1998 are attached for your review.

** Note that the indicated rates of return are the historical total returns over the periods noted, including changes in unit value and reinvestment of all distributions. These indicated rates of return do not take into account any redemption charges that may have been payable by redeeming unitholders, which would have reduced the returns of redeeming unitholders in certain circumstances. Please refer to the Offering Memorandum for details concerning the redemption fee schedule of the Fund. In addition, note that performance data represents past performance and is not necessarily indicative of future performance.*

Investment Philosophy: Portfolio Composition

NB: A "long" position signifies actual ownership of a stock - the Fund expects the stock to rise in price. A "short" position signifies that the Fund has sold the security without ever owning it. In a short sale, the Fund hopes to buy back the security at a lower price in the future thereby making a profit.

As most of you are already aware, the Fund made a significant change in the scope of its operations in December of 1997. Broadening the mandate of the Fund's activities to include short selling and leverage gives us more opportunity to earn positive returns in all market environments.

Since the change was implemented (first week of December 1997), the Fund has averaged a portfolio composition (expressed as a percentage of the Fund's equity) of 100% - 125% long and 20% - 30% short. In other words, the Fund has been leveraged between 20% and 55% above its equity levels.

There are two benefits to splitting the use of leverage across long and short positions. Firstly, to the extent that the market as a whole corrects, our short positions should afford us some protection. Secondly, our short positions generate interest income, helping to offset the cost of leverage incurred on the long side.

Barring an extreme investment climate, I expect that the Fund's portfolio composition will typically range between 80% - 120% long and 20% - 50% short. This would leave us with net market exposure between 30% - 100% of equity. In deference to the market's historical tendency to rise, I think it is a good policy to maintain a positive "tilt" in our net market exposure. As well, this positive tilt recognizes that good short sale ideas are fewer and further between than good long ideas.

Going forward, I believe that the Fund will generally have more difficulty in locating as many short sale ideas as long ideas. This probably reflects two important facets of our capital markets: i. a tendency on the part of brokers to emphasize positive events (especially in their printed material where "Buy" rankings outnumber "Sell" rankings by a factor of 10 to 1) and, ii. our innate sense of optimism. Clearly, I will have to devote more time to finding short ideas.

Investment Philosophy: Stock Selection

The Fund's operating philosophy can best be described as ... "Buying good businesses and shorting troubled companies." While this is our primary focus, the shortage of qualified candidates combined with the need to essentially stay fully invested (you haven't given me your money to buy treasury bills) dictates that the Fund's operations include ... "Buying OK companies (at cheap prices) and shorting OK companies (at expensive prices)." The Fund's preference and its greatest weightings are reserved for the former situations not the latter.

So, what then is a "good business"? My definition includes the following key attributes: i. a relatively **certain positive** return on invested capital and, ii. a relatively **high** return on invested capital (as compared to the universe of other companies' "certainty" and "quantum" of return on capital). In terms of prospective purchases, the Fund values acertain 20% per annum average annual return on equity more greatly than an uncertain 50% average annual return on capital. In baseball parlance, the Fund is attempting to hit "singles" and "doubles" not "home runs".

Unfortunately, it is rare to be able to purchase "good businesses" at prices that can be considered inexpensive. The constant debate in considering these purchases is one of price versus quality.

At the opposite end of the spectrum, the Fund attempts to locate short sale positions that feature very uncertain business futures (i.e., low or negative returns on invested capital) and, preferably, highly leveraged balance sheets (further exacerbating the low or negative returns on invested capital). To date, I have not been able to locate many such candidates for the Fund.

The Fund's "Core" Positions:

The Fund's core positions each typically account for 5% or more of the Fund's portfolio. As well, a core position is one in which I have a high conviction level and am prepared to wait for some time for the stock price to approach my definition of value.

The Fund currently has six core positions, four on the long side and two on the short side. As of March 31, 1998, these six positions accounted for 37.3% of the Fund's portfolio.

As in last year's Annual Report, the following discussion is intended to summarize the thinking behind each of the Fund's "core" positions. I'll do my best to keep it short and less technical than last year's tome.

The following discussion of the Fund's core positions includes estimates of future results and target prices that are, except where otherwise indicated, based on my analysis of publicly available information respecting such companies. There can be no assurance that such results will be obtained or that the market value of such securities will approximate their target prices.

Long Positions

Canadian Medical Laboratories Limited ("CML") - common shares and warrants:

CML provides medical diagnostic services in Ontario and, contract research organization ("CRO")/site management organization ("SMO") services to the pharmaceutical, biotechnology, and medical devices industries in Canada and the United States.

CML's beginnings and historical growth has come from its Ontario lab operations. This is a boring, high margin (30% plus EBITDA margins - "earnings before interest, taxes, depreciation and amortization") business which essentially involves operating a wide network of "collection centers". These centers collect samples from doctor's offices and hospitals and send the samples to a central lab which then processes the samples for a fee. CML is in the top five in lab volume in Ontario and is one of only three Ontario lab operators who are publicly traded.

While the Ontario lab companies operate under a regulatory "price cap" regime, thus limiting current growth, the offset is that acquisitions of competitors can lead to superior margins. Furthermore, recent changes to the "price cap" essentially fix each operator's market share, making acquisitions more attractive since there is less risk of revenue loss post-acquisition.

What's exciting about this boring business is threefold;

i. There is a tremendous consolidation wave going through the Ontario industry. While only three years ago there were over 40 lab operators, today there are just over 20. For the smart operators, this consolidation trend generates greater margins as more volume (through acquiring your competitors) can be pushed through fewer remaining labs. CML's EBITDA margins have actually risen since the price cap era from approximately 20% to 30% plus.

ii. There are no new lab licenses being issued in Ontario. Therefore, CML's current market share is not likely to slip, cementing its "quota" value if nothing else.

iii. The Ontario hospitals' internal lab work, which roughly equals the volume of non-hospital lab work done in the province, are beginning to outsource their volumes (in an effort to streamline their cost structures). It is feasible, assuming that current market shares are not altered, that CML could double its current volume of business. Such growth in volumes would likely lead to even greater earnings potential despite the likely lower margins accompanying the hospital sourced work.

I believe that CML's lab operations are worth $10 to $12 per share (I use an enterprise value/EBITDA approach to value the lab business, as follows: 6X to 7X EBITDA minus total debt plus cash on hand).

The CRO/SMO business, which consists of performing various aspects of research and development on behalf of pharmaceutical or biotechnology companies and managing multi-site clinical investigations on behalf of such companies or other CRO's, is more of a wildcard. However, given that CML has partnered with some strong organizations, brought in experienced senior management and, given the prevailing estimates of the potential size of this division two to three years out, I think another $2 to $3 of value per share can be ascribed.

As a final note, CML has all the other characteristics the Fund seeks in a long position, specifically; lots of free cash flow (from the lab business), a clean, unlevered balance sheet, management equity ownership (in this case 50% plus), management continuity (the President and C.E.O. started the business in 1971) and relatively little research coverage from the brokers (not yet anyway).

Target Price: $12 to $15 per share ($6 to $9 per warrant - the warrants have a $6 exercise price and expire in November, 1998).

<u>Chapters Inc. ("Chapters") - common shares:</u>

Chapters is the largest book retailer in Canada and the third largest in North America. Formed through the merger of SmithBooks and Coles, Chapters operates book superstores under the Chapters banner and traditional bookstores as SmithBooks, Coles and The Book Company.

Chapters is executing a long term business plan that features accelerated development of the superstore concept (a concept that is proving particularly well-suited to book retailing) and the paring back of weaker performing, traditional, mostly mall-based stores. While this process is capital intensive there are benefits to being the first to market (e.g., better sites, more favorable lease terms, higher consumer awareness, etc.).

As Chapters builds out its superstores, earnings, even net of the inevitable dilution caused by the need for additional equity capital, should rise strongly. This reflects the benefits of greater operational efficiencies as Chapter's overall volumes grow and the tendency for a given dollar of superstore revenue to be more profitable than a given dollar of traditional storerevenue.

The U.S. experience with Borders Group, Inc. and Barnes & Noble, Inc. has shown that, the advent of superstores actually drives greater per capita consumption of books. Encouragingly, Barnes & Noble has become a large shareholder of Chapters and is helping Chapters management execute its business plan.

As well, our position in Chapters benefits from a Canadian cultural protection policy which limits foreign ownership of Canadian book retailing enterprises. Thus, Chapters' competition, at least over the next few years, will be limited to other domestic retailers, none of which are close to Chapters' size.

I expect $1.75 to $2.00 in earnings per share in fiscal 2000 (March 31st fiscal year end). Assuming a 25X price/earnings multiple (US comparables trade at 30.5X trailing earnings), our target price one to two years out is $43.75 to $50.00. (Those of you who are aware of the inadequacies of P/E ratios as a valuation tool can call me directly to discuss CHP's Enterprise Value/EBITDA.)

Target Price: $43.75 to $50.00 per share

<u>Mainframe Entertainment, Inc. (Mainframe) - common shares:</u>

Mainframe is an integrated "computer generated imaging" ("CGI") animation company which creates, develops and produces television and, in the future, movie entertainment. Mainframe's goal is to be one of the leading CGI animation producers in the world, building a library of proprietary products to generate revenue from television programming, feature films, home videos, CD-ROMs and, merchandising and licensing of related products.

Anyone who had the patience and fortitude to read my last Annual Report, will know that I am a fan of so called "content providers". These are companies that produce television and/or movie programming to fill the ever expanding number of channels and movie screens around the world. Mainframe is a holdover from this theme which pervaded our portfolio last year.

What sets Mainframe apart from other animation "content providers" is its proprietary three dimensional ("3D") technologies and processes. The uniqueness and value of these technologies and processes is evident in Mainframe's highly-rated and award-winning series; *ReBoot* and *Beasties* (*Beast Wars* outside Canada). The success of *ReBoot* and *Beasties/Beast Wars* in North America is rapidly leading to additional orders for these original series. As well, Mainframe has been hired to develop two other animated series; *War Planets* (in agreement with U.S. toy maker Trendmasters) and *Weird-Oh's*.

In total, while Mainframe delivered 29 half hour episodes in fiscal 1998 (fiscal year end is March 31st), 78 are expected to be delivered in fiscal 1999 and over 100 are expected in fiscal 2000. Further deliveries will likely be scheduled between now and fiscal 2000.

The "icing on the cake" will come, when and if Mainframe announces an agreement with a major Hollywood producer to create an animated feature film using Mainframe's technology. The company has already signed a deal with Paul Allen's Storyopolis, Inc.

(Paul Allen is the other founder of Microsoft Corporation and has proven to be an astute investor since exiting Microsoft) for the purpose of developing such a feature film from a well known children's tale (the backing of a large studio/producer is still needed).

The value of Mainframe's business is not just in the distinctive visual presentation (very lifelike) but also in its relative cost effectiveness (e.g., as compared to the cost to produce Pixar, Inc.'s *Toy Story*). As Mainframe builds up its library, its earnings should grow dramatically. This is the kind of business where tremendous leverage exists, you can keep selling the same item over and over again. After the first few sales, the costs have largely been provided for, leaving room for substantial margin improvement going forward.

As well, if my six year old son's voracious appetite for Beast Wars action figures is any measure to go by, Mainframe's merchandising royalties will show good growth. This is especially true now that Mainframe is in a better financial negotiating stance for setting terms on merchandise sales royalties (i.e., its initial public offering proceeds have given it additional negotiating leverage).

From my usual laundry list of items I like to see in a long position, Mainframe is only lacking in terms of historical record of profitability. Simply put, the Company has not been around long enough. However, I feel that my comfort with the general outlook for "content providers" and in particular with this sort of a niche player more than offsets the relative absence of a long term track record.

My guess is that Mainframe will attract a valuation multiple going forward roughly equivalent to that of its U.S. comparables. If this is the case, 25X to 30X earnings per share is a fair estimate of future valuation. Based on a forecast of $0.60 in earnings per share in fiscal 2000, a reasonable target price would appear to be $15.00 to $18.00 per share.

Target Price: $15.00 to $18.00 share.

Hudsons Bay Company ("HBC") - common shares:

HBC operates the traditional department store chain "the Bay" and the discount chain "Zellers".

In 1997, the Fund benefited from the stock price performance of one of last year's core positions - Silcorp Limited ("Silcorp"). HBC's current situation, while on a much larger scale, reminds me of Silcorp in late 1996. Not unlike Silcorp's purchase of Beckers Inc., HBC's Zellers division purchase of K-Mart stores should rationalize the Canadian discount department store industry sufficiently so that all the participants gain (i.e., Walmart Canada will also benefit).

The greatest benefit should accrue to HBC though, as there are numerous areas for cost-cutting (e.g., shared advertising expenses, elimination of duplicate overhead expenses, elimination of underperforming stores and greater purchasing economies of scale).

I expect HBC's earnings per share two years out could reach $2.50 to $3.00 per share. Assuming a 15X to 18X P/E multiple (a conservative range in light of current comparable valuations), HBC shares could command $37.50 to $54.00 in one to two years time.

Target Price: $37.50 to $54.00 per share.

Short Positions

Royal Oak Mines ("RYO") Inc. - common shares:

RYO is a North American gold mining company. It currently operates two mines - the Pamour and Giant mines. As well, the company is actively bringing on stream a third mine (which is substantially larger than RYO's other mines) known as the Kemess Mine ("Kemess"). Essentially RYO has bet its corporate future on Kemess.

Largely as a result of the massive capital cost of developing the Kemess mine, RYO has a heavily-leveraged, cash absent balance sheet. Recently, while desperately in need of Cdn.$40 million plus to complete the start up of Kemess, the company managed to secure an emergency source of cash through the issuance of US$120 million of senior secured notes (the "notes")(subject to the approval of the senior subordinated noteholders which is **not** a given). While these notes stave off the threat of bankruptcy in the short run, they are a very expensive piece of capital (interest rate set at LIBOR plus 6% = approximately 12.5%), they are short term in maturity (due in approximately two years) and, given their senior security feature - one wonders if RYO hasn't effectively handed over title to Kemess already.

The proponents of "efficient market hypotheses" should take a look at RYO. With or without Kemess, the company has little asset value (let alone, **net** asset value). In fact, even after placing a generous valuation on Kemess, I can't generate a valuation for RYO in totality that exceeds its debt levels! And, I think there is a real risk, based on comments from other mining executives, that Kemess does not work as well as planned(the mining business is not given to accurate predictions of the economics of start-up operations - often there is disappointment after start-up).

Despite (or perhaps as a result of) the note financing, I believe that RYO will continue to face the need for a fundamental restructuring of its balance sheet. In a restructuring, massive share dilution will be the order of the day, as much of the debt will have to be converted to equity.

Currently, RYO's equity market capitalization is Cdn.$236 million - very expensive given the quantity and nature of corporate debt and the relatively small asset base underlying the company. Taking into account the US$120 million of senior secured notes to be issued and the approximate US$40 million of senior secured debt to be repaid, the company will have approximately Cdn.$478 million of debt (all of which ranks ahead of the equity in a restructuring) with an average interest cost in excess of 11%.

I believe that the stock is materially overvalued. The catalyst to force recognition of this valuation inefficiency could be the inability of RYO to service its massive debt load. Our risk in being short is the potential for a strong, sustained recovery in gold and/or copper prices.

Target Price: $0.20 to 0.50 per share.

Crystallex International Corporation ("KRY") - common shares:

KRY is a Canadian-based mining and exploration company. It operates a small scale gold mine in Venezuela (the "Albino" mine) and is pursuing ownership through the Venezuelan judicial system of a large prospective gold property in Venezuela known as "Las Cristinas". For the last three years, Las Cristinas has been explored, drilled and developed (to a cost of approximately US$125 million - out of a total estimated capital cost of US$590 million) by a joint venture 70% owned by Placer Dome Gold Inc. ("Placer Dome")(one of the world's largest gold mining companies) and 30% owned by the Venezuelan state mining company.

I suspect that KRY is worth substantially less than what the market is currently willing to pay and I suspect that the company's prospects have been over-promoted. There is alot ofcircumstantial evidence to at least begin to assume that KRY has been "hyped" by the insiders.

My approach to studying KRY was to first gauge the downside risk in being short. The greatest risk would be if KRY were to "win" 100% ownership of Las Cristinas - a very unlikely development.

Taking Placer Dome's public information releases concerning the expected production profile of Las Cristinas (annual production rate, expected cash cost per ounce of gold for a given level of byproduct credit, expected capital cost and expected development time),assuming two polar extremes of how KRY might finance the development of the mine (100% equity on the one hand and 100% debt on the other hand) and, taking a composite of market valuations of senior gold companies (a higher valuation range than that afforded mid-cap to junior mining entities), I developed a range of share valuations. **These valuations were all below KRY's share price and were for a period two to three years out since the mine would not be operational at the earliest until then!** In other words, the market was valuing KRY at a premium to what it would be worth even if it did win Las Cristinas - again, an extremely unlikely event. Furthermore, KRY has no other assets that come remotely near to the valuation level required to support the share price.

Admittedly, with a non-threatening downside, worst case scenario, one is tempted to "load up" on the position. However, in this case a more cautious approach is justified given the propensity for the stock to be promoted upwards.

Above and beyond the valuation gap that exists between reality and KRY's share price, further impetus to sell short could be drawn from the following suspicious or unusual items:

a. Extremely aggressive use of management share options and repeated management share selling.

b. Excessive management promotion of KRY's **potential** claim on Las Cristinas.

c. Issuance of "lesser-than-convertible" securities - the convertible security's conversion price is a function of the share price **when the convertible holder decides to sell minus a discount**. The issue did not require a prospectus, is extremely detrimental to the going-forward value of KRY's shares (since the capitalization of the company becomes open-ended) and was disguised as an "equity line of credit"!

d. Substantial increase in operating costs in recent quarters. In the quarter ending September 30, 1997, salaries jumped to $1.1 million (versus $197,849 in the year ago quarter) and investor relations consumed $159,823 in the quarter alone.

Target Price: $1.00 per share.

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

Peter Puccetti, CFA
Chairman & Chief Investment Officer

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