September 30, 2014

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
September 30, 2014

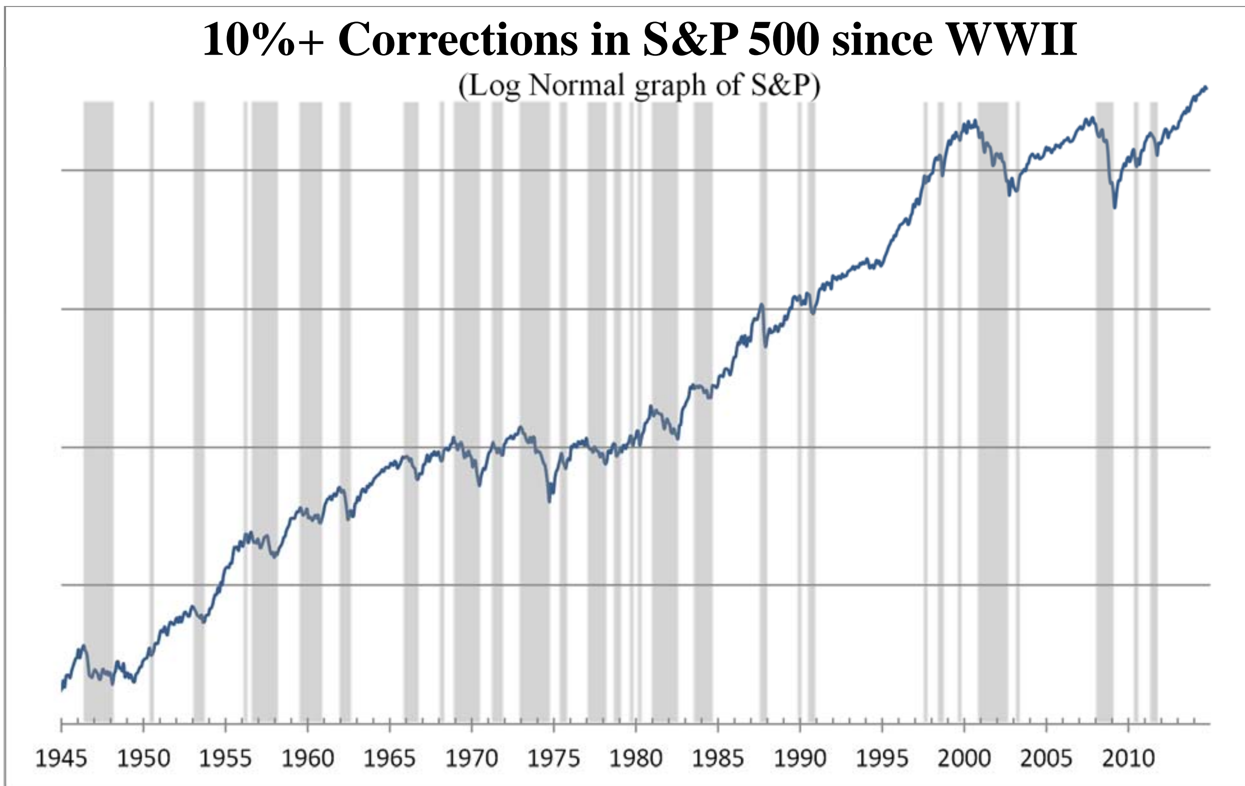
Rates of Return[1]

	3 Mths	YTD	1 Yr	2 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception March 31, 1993
DK EQUITY GROWTH	**-1.7%**	**20.5%**	**28.1%**	**14.9%**	**10.4%**	**11.2%**	**15.6%**	**14.7%**	**15.7%**
S&P/TSX Composite Index	-0.6%	12.2%	20.4%	13.6%	8.7%	8.5%	7.7%	8.8%	9.3%
S&P 500 (in U.S. Dollars)	1.1%	8.3%	19.7%	19.5%	15.7%	8.1%	4.9%	9.6%	9.2%

North American broad market indices pulled back from their 2014 highs this quarter. The Canadian S&P TSX index peaked at 15,657 on September 3rd and closed at 14,960 September 30th (4.5% decline). In the U.S., the S&P 500 index peaked at 2,011 on September 18th and then closed at 1,972 on September 30th (1.94% decline). In October these indices continue to trend downward.

There has been much chatter, speculation, and angst in the media regarding a possible market correction or bear market. Typically a "correction" refers to a decline of 10% or more, and a "bear" market refers to a decline of 20% or more. There are some very important points to understand about corrections/bear markets. For investors, it is important to recognize that corrections/bear markets are NORMAL, not abnormal, occurrences. They occur with regularity over time. Looking at historical data for the S&P 500 since WWII, this broad market index has seen corrections of 10% or more 27 times. Bear markets (-20% or more) have occurred in 12 of these instances. Although they have not been evenly spaced, we have had a correction, on average, every 30 months.

[1] Returns longer than one year are annualized gross of management fees.



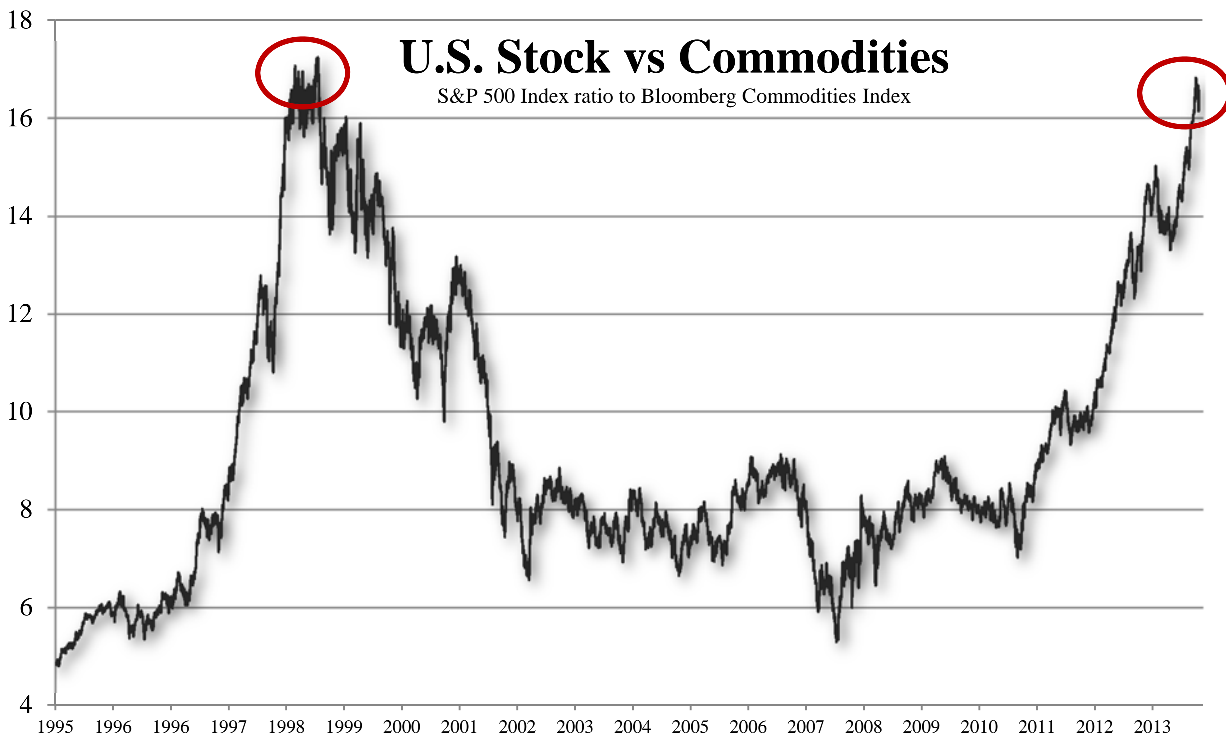
Taking a look at the above graph, we can see the number of corrections since WWII. The areas in grey represent the market corrections of 10% or more and their durations. We can see that the corrections vary both in magnitude and in length. They feel bad each time, but every time the market has recovered to reach new highs. We've been through it before, we will recover again.

It is also important to recognize, and accept, that these events are unpredictable. Yes, there have been stock market gurus who after the fact, have taken credit for predicting them. But these experts are long forgotten. Probably because they forgot to tell investors to buy back in at the bottom! If we have liquidity going into a correction it is wise to invest in target companies at cheaper valuations. Otherwise, without cash, grin and bear it.

Although in each and every correction and bear market we have experienced, there is a plethora of learned mavens that will tell you "TTID" . . . this time it's different. You are wise to ignore them. The corrections and bear markets, as painful as they feel at the time, hardly register in a long-term graph of the market. The most important thing to remember is this . . . there have been 27 corrections since WWII . . . and there have been 27 recoveries. Will it be TTID?

The Deans Knight portfolio valuations followed a similar path as the broader TSX Index over the past quarter. Most of the downside was felt in the oil and gas sector. This was caused by a decline in the price of crude oil, which went down from a peak of $103.01 on July 1st to close out the quarter at $91.16 (11.5% decline). Our natural gas producers followed suit, as the price of NYMEX gas followed a similar decline path to crude oil. The metals sector, where we have very little money allocated at this time but have been gradually building two positons, was also under some downward pressure.

We came across a very interesting graph recently. The graph shows the ratio of the S&P 500 index to the Bloomberg commodity price index over the past 20 years. It highlights that in the late 1990's the S&P was soaring on the back of the dot-com stocks and commodities were swooning because of global growth concerns. Subsequently, over the ensuing decade, commodities outperformed the S&P. Since the recession of 2008/09 we have seen a reversal again… strong appreciation of the S&P and declines in commodities. The graph is back to its previous peak.



While we cannot predict the future we can revisit the last peak. We lived through the 1998/99 period. The broad market indices were pushed to higher and higher levels by the dot-com stocks and a flood of capital inflows trying to capture the rising market. As you will recall, Nortel was 30% of the index at one point. Energy, mining and simple manufacturing businesses were left behind. With the Asian Crisis, the Russian Debt Default, the demise of Long Term Capital (a major hedge fund in the day) and a 60 cent Canadian dollar, oil and base metals plunged and valuations of non-sexy businesses languished.

How did we react? We looked for areas where we found a potential for earnings growth at reasonable valuations. No different than before. There was a significant amount of value to be found in the resources, materials and forestry sectors - where many companies were trading below book or replacement cost. We also eliminated our positions in companies we didn't believe could weather the storm - leaving us with the lowest cost producers with the best management teams. When the reversal came, it was stunning and our valuations soared. Could it happen again?

During this past quarter, we reduced our holdings in a number of oil producing investments. We sold our position in **Athabasca Oil Corporation**. One of our key investment criteria is that we need to have continued confidence in, and a dialogue with, management of companies that we entrust our client monies with. Although Athabasca Oil Corporation is an asset rich company, there has been significant turnover among the ranks, including at the very top. For us, in spite of the assets, without that confidence and dialogue with management, we get uncomfortable. We sold our position in **TORC Oil & Gas Ltd**. as well as approximately 1/3 of our shares in **Parex Resources Inc.** TORC has a great management team and asset base, however we are trimming the portfolio to focus on what we believe are the best names with the greatest growth potential. Parex is still a core investment, however the valuation tripled in the past year and the holding became roughly 10% of the total portfolio. We sold to lock in some profits, and to have funds available for other opportunities.

In that regard, we added two core positions. . . **New Look Eyewear Inc.** and **Pine Cliff Energy Ltd**. We have followed both for some time, and it has been a challenge to get a meaningful position in place. In both cases the companies made acquisitions during the quarter and each did an equity issue to fund a part of the acquisition cost. Because of the solid relationships that we have developed with both management teams, we were able to take down a significant portion of each issue. A background of New Look Eyewear Inc. and Pine Cliff Energy Ltd., and the rationale for why we want to be involved is below.

New Look Eyewear Inc., which we introduced in the prior quarterly, aims to be the leading industry consolidator for the fragmented optometrist and prescription eyeglass business in Canada. During this quarter, the company announced the purchase of Greiche & Scaff, their nearest Québec competitor. New Look will acquire 49 stores and a lens manufacturing facility, which generates Greiche & Scaff $30.7 million in revenue. Reduced corporate overheads, along with purchasing and manufacturing synergies lead to projections of improved EBITDA of over $3 million which translates to acquisition metrics of 6x adjusted EBTIDA. New Look raised a combination of debt and equity to complete the purchase, of which Deans Knight obtained 80% of the equity issue on behalf of our clients. Management recognizes that we are supportive and long term shareholders. Post-acquisition, New Look will operate 190 retail locations generating an estimated $160 million in annual revenues and $30 million in EBITDA.

Pine Cliff Energy Ltd., run by George Fink and Philip Hodge, is focused on acquiring and developing low risk, low maintenance, long life natural gas assets in Western Canada. George is the founder of Bonterra Energy, which has created significant value for its shareholders throughout several market cycles. He embodies Deans Knight's core management values - he's competitive and focused, always honest and has the utmost respect of his industry peers. Pine Cliff management is focused on growing per share value over the long term. In 2014, they have completed acquisitions which bring production from 4,000 barrels of oil equivalent/day ("boepd") to an expected exit rate of over 12,000 boepd. The 2015 operating cash flow will be over $60 million, with free cash flow of over $25 million. We are currently paying 5.5x EV/2015 cash flow. We believe this is a compelling valuation considering the premier management team who has a pipeline of acquisition opportunities. The company is uniquely positioned - they are highly levered to the price of gas, but due to the low cost nature of their assets, they can remain profitable

at lower prices and will have capacity to buy assets for less. It is as close to a win-win as you can get in a commodity dependent, cyclical industry.

In July, we received an all cash takeover bid for **Contrans Group Inc.**, our trucking company, from Canada's largest trucking company, **TransForce Inc.** We were not surprised. We have been involved as a shareholder of Contrans since we made our first investment in the company during the "great recession" in 2009. The experience has been a very good one for us. We received a steady stream of dividends along the way, with consistent growth in shareholder value. Stan Dunford, the Founder and CEO, owns close to 15% of the shares, and Deans Knight clients collectively are the second largest shareholder with 11.4%.

Stan felt it was the right time to monetize the company. It was his preference to seek an all cash bid rather than a share exchange. His view, and we accept it, is that trucking stocks have been on a roll and that he did not want to accept expensive paper in exchange for Contrans Group Inc. We voted your shares in favour of the transaction. The TransForce offer, which was originally open until September 17, has been extended until the end of October. Contrans represents roughly 6% of your portfolio, which, if the transaction goes ahead as envisioned, will generate cash for the portfolio to put to work in other situations.

There may be a lot of uncertainty and concern about the slowing growth in the global economy, about a slowdown of growth in China, and about many other things that we nor others can predict. If we concede that we cannot predict or foresee the future, what can we do? We can stay close to our investee companies and management and ensure that they are continuing to build shareholder value. This past quarter we have had meetings with the majority of the leadership who run our companies. They are all on plan. They are doing what we expect them to do to create value for you, the owners. Below is a short, bare bones, up-to-date description of a number of our core holdings and why we own them. Next report we will highlight another group of them.

Linamar Corporation is a leading North American autoparts supplier founded by Frank Hasenfratz and currently run by his daughter, Linda Hasenfratz. The family owns 30% of the company. The company's success is based on its culture of innovation where they design and develop highly engineered product for their clients. Following the financial crisis, in an effort to streamline their supply base, North American auto makers eliminated many smaller suppliers and chose to stick with a select group of top tier suppliers, which included Linamar. This allowed the company to double its business in the subsequent 5 years. The company is now operating at record margins and continuing to win business in North America, Europe and Asia. As a result of their success, the share price has appreciated 140% in the last eighteen months. That said, it trades at a reasonable 12 times earnings. Management believes their $3.2 billion launch book should allow them to reach $7 billion in sales in the next five years, up from the current $4 billion. While we've decided to realize a portion of our profits through selling roughly 15% of the position, this name will remain a core holding given the quality of management, strong product innovation and trajectory of business wins.

We have been long term supporters of Wayne Foo and his team at **Parex Resources Inc.** They have a proven track record of creating value in the oil field. Since forming Parex in 2009, Wayne's team has demonstrated exceptional growth. In 2010, Parex had 10.4 million in proven, probable and possible (3P) reserves; today they have over 90 million. They have grown from 1 producing field to 24 and will exit the year at over 25,000 boepd. They have stated that they will grow production at 5% per quarter, which doubles production in less than 5 years. Parex is currently funding all their development through cash flow. With excess cash after development, and minimal debt, they have a balance sheet that allows them to make further investments. This success has been reflected in the market value, which has grown from its initial price of $3 per share in 2009 to over $12 today, a 25% annualized return.

Heroux-Devtek Inc. is the world's third largest manufacturer of aircraft landing gear. Simply put, we own this company because of its founder and CEO, Gilles Labbé, whom we've known and respected for many years. Gilles owns 10% of the company and manages it with a no-nonsense, detail focused approach. In 2013, Heroux won a landmark contract with Boeing to supply the complete landing gear system for the 777 and 777x aircrafts. Shortly thereafter, Heroux purchased a smaller European competitor APPH, thus opening new markets and new customers including another dominant player, Airbus. Today we are paying a reasonable 8.5 x 2015 EBITDA; forecasted to be around $50 million and which doesn't include any contribution from the Boeing contract. We have faith that Gilles' ability to deliver effectively on the Boeing contract will help the company double in size and expand margins in the next 5 years.

Paramount Resources Ltd. is founded and run by the widely respected Riddell Family who own approximately 40% of the company. Paramount recently spent $250 million on a gas processing facility, which has the capacity to process up to 50,000 boepd. The company currently produces 20,000 boepd which will grow to 70,000 by the end of 2015. At full capacity, the plant can produce more than $800 million in free cash flow, which the company will put towards the development of two more gas plants. This expansion should see corporate production grow to 140,000 boepd by 2017, which could yield as much as $2 billion in annual cash flow; a seven fold increase in just three years. The company is currently worth $6.5 billion, we believe the company is worth much more given their growth trajectory, substantial resource base, and reputable and invested management team.

West Fraser Timber Ltd. is the North American leader in forest products including lumber, pulp & paper and panels. The Ketcham family, who founded the company in 1955, created a culture where every employee is dedicated to low cost operations. The Ketcham's know that being the lowest cost producer is a distinct advantage when operating in a competitive market where pricing is out of their control. During the Great Recession, West Fraser maintained positive cash flow from operations, reinvested over $800 million in their capital assets and reduced their balance sheet debt by over $200 million; all while peers struggled to remain solvent. Market conditions have improved dramatically since 2009 yet management, led by new CEO Ted Seraphim, remains focused on low costs and maintaining a prudent balance sheet. We purchased West Fraser in 2008/09 when housing starts in the U.S. were as low as 700,000; we continue to hold the investment as we believe there is further growth. Currently the U.S. reports less than 1 million housing starts annually, while new demand from China is equivalent to approximately 400,000

new homes. It reasons that any increase in U.S. housing starts, which has historically averaged 1.5 million, should have a material effect on lumber pricing.

Tourmaline Oil Corp. was founded by Mike Rose, with whom DK successfully invested in his previous company Duvernay Oil Corp and which was sold in 2008 for $5.9 billion. Mike owns over 6%, or $600 million of Tourmaline, which demonstrates his alignment with investors. In 5 short years, the team has proven their ability to create shareholder value. Production has risen from zero to 120,000 boepd and will exit 2015 at over 200,000, a 66% increase from today. Cash flow per share has grown from $1.10 to an expected $7 by 2015. Tourmaline's vast resource base includes over 9,000 drilling locations and 590 million barrels, which is approximately 13 years of reserve life. As one of the lowest cost producers, Tourmaline was able to stay cash flow positive even at the historically low gas prices realized in 2012. At $10 billion in enterprise value and $1.5 billion in projected cash flow for 2015, Tourmaline is reasonably valued at 7x; especially when we consider they plan to double their production in the near term.

Velan Inc. is a leading manufacturer of industrial valves for industries like power-generation, oil & gas, water & wastewater, etc. The company has manufacturing operations at 17 plants in 11 different countries. It was founded by A.K. Velan, who sits as Chairman, while his sons Tom and Ivan handle the day-to-day operations. The family holds a controlling stake (80%) while Deans Knight clients, collectively the largest external shareholder, hold more than 30% of the remaining float. When Velan became a public company in 1996, initially trading at $17, it had a book value of $6 per share. On September 30th the stock closed at $17.36 while the book value has nearly tripled to $16.50. This plainly shows the underlying, yet unrecognized, value that has been created. Operational results have been consistently positive in recent years with revenue, backlog and margins all improving steadily. The company currently holds more than $5.00 per share of cash, pays a 2% dividend and trades at 5.5x EBITDA. We believe the company will be sold one day for considerably more than today's market value. We don't know when this will happen, but we are comfortable with the trajectory of the business in the meantime.

Winpak Ltd. is the textbook example of the type of business we look for at Deans Knight. Bruce Berry, CEO, was the second employee when Winpak was founded in the late 70s and is an A-plus manager. When the majority shareholder, the Wihuri family, decided to expand their successful European business into North America, Bruce and his partner were hired, and have grown the business from start up to a $1.7 billion market capitalization. They have done this while accessing the capital markets only twice since IPO, last in 1993. The flexible packaging materials and machines that they offer to their clients are innovative, highly engineered and result in long term 'sticky' customer partnerships. Furthermore, the capital investment needed to replicate the business and the proprietary nature of their products create barriers to entry. The company is free cash flow positive, debt-free and is investing back in the business. They will spend $55-65 million this year to add capacity for new product offerings. Winpak will exit 2014 with approximately $800 million in revenue, $110 million in EBITDA and $40 million in free cash flow. Bruce has a goal to bring revenues to $1 billion or greater by the end of 2015; their recent double digit organic growth is placing them on a steady path to this goal and we are a happy and supportive shareholder.

With the acquisition of three sawmills from producers that went bankrupt in the 2008-09 recession, **Conifex Timber Inc.** became the newest lumber producer in BC. The leadership team of George Malpass and Ken Shields are aligned with shareholders, and together with their managers and directors, own over 9% of the company. Malpass was the very successful operator of Primex Forest Products - a BC lumber producer that was profitable for the duration of his management and was ultimately purchased by International Forest Products in 2001. Shields is a former investment banker who understands the capital markets and has an extensive forestry background. Conifex has a valuation of $250 million and generates cash flows of approximately $30 million. A multitude of opportunities exist for Conifex to improve its performance in coming years. Regarding the top line management recognizes that their competitors have strong North American customer relationships and therefore make a concentrated effort to direct a material amount of Conifex's sales to the Asian Market where they are creating new demand. At the bottom line the company currently produces at operating margins roughly half that of the industry incumbents. The team believes through diligent management, they can improve the company's profitability dramatically. A big part of this improvement will come from their bio-energy plant, which was completed in September 2014. When fully operational, the plant is expected to generate as much as $15 million of cash flow per year. Furthermore, the government is considering granting additional cutting rights in the area of Conifex's mills. If this materializes they would be able to ramp up operations dramatically, potentially bringing on their idle third mill. Lastly, the industry is facing increased demand from both Chinese exports and rising housing starts in the U.S. Any material increase in either of these factors should prove positive for the lumber price and Conifex's bottom-line.

Uni-Select Inc. is the largest distributor in Canada and 5th largest in the U.S. of after-market auto-parts, and the largest auto paint distributor in the U.S. Historically, the company's U.S. operations have struggled with cost inefficiencies and strong competition. We initiated our investment in July of 2013, shortly after Robert Chevrier had been brought on as Chairman. Chevrier is known as a turnaround artist, having brought Westburne Inc. back from the brink of bankruptcy in the 1990's to reach record profits by 2000. Since his arrival, Chevrier has optimized or closed underperforming locations, reduced inventory and improved IT systems. While the company has shed $30 million in unprofitable sales, EBITDA has improved 32% and free cash flow improved 63% to $72 million - these improvements have resulted in a stock price appreciation of roughly 40%. That said, we believe there is more to come. Now that the existing U.S. business is back on track and the Canadian business continues to thrive management is focused on both organic growth and acquisitions. Management believes they can grow at 4% organically and their free cash flow can buy an additional $100 million in revenue, or 6% growth by acquisition. We also believe the auto-paint business, Finishmaster, being the dominant player in the U.S. has significant value that is not recognized in today's current market value.

In closing, one more comment regarding man's inability to forecast accurately. This past summer the Wall Street Journal published a piece where they revisited an edition from the summer of 1989. At that time, they interviewed a group of learned, important people and asked them to look at the world 25 years out. Interesting to look back at some of the predictions. When asked to predict what country had the brightest economic future over the ensuing 25 years, guess which country topped the polls? **Zimbabwe!** Enough said.