**March 31, 2016**

# DK INCOME FUND

DEANS KNIGHT

CAPITAL MANAGEMENT LTD

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## Quarterly Report
## March 31, 2016

Research has shown that the longer term returns from a bond, or a bond fund, are largely determined by the yield-to-maturity, or income earned, on these bonds. Changes in the market prices of bonds plays a much smaller role in determining those long-term returns. The objective of the DK Income Fund, since its inception in 1993, has been to maximize that income earned by investing in higher yield debt instruments, while protecting capital by emphasizing our own internal credit research.

The adjacent table details historical information since the inception of the DK Income Fund. It shows the annual income earned, price changes, and total return.

- The annual income earned has been relatively stable in a range of 7 – 10% per year.

- Bond prices can be volatile as they trade in the market prior to maturity, but they always trend back to par value closer to maturity dates. Bond price movements account for a small part of total long-term return.

- The annualized income generates almost 90% of the long-term return.

Our focus on generating high income earned has produced a 10.2% annualized return since the inception of the Fund in 1993. This return not only exceeds the return on the government bond index by a wide margin, but it has also produced a return exceeding the higher risk TSX stock index.

**Deans Knight Income Fund Historical Annual Returns:**

| Year | Income Earned | Price Movement | Total Return |
|---|---|---|---|
| 2016 YTD | 1.5% | 0.0% | 1.5% |
| 2015 | 8.4% | -8.1% | 0.3% |
| 2014 | 7.9% | -3.8% | 4.1% |
| 2013 | 7.2% | -7.1% | 0.1% |
| 2012 | 8.2% | 2.7% | 10.9% |
| 2011 | 8.3% | -4.1% | 4.1% |
| 2010 | 7.7% | 10.6% | 18.3% |
| 2009 | 11.5% | 49.1% | 60.6% |
| 2008 | 9.4% | -29.7% | -20.3% |
| 2007 | 8.5% | 7.2% | 15.6% |
| 2006 | 9.0% | 0.1% | 9.1% |
| 2005 | 9.3% | 11.6% | 21.0% |
| 2004 | 9.7% | 15.9% | 25.5% |
| 2003 | 10.1% | 17.1% | 27.2% |
| 2002 | 9.9% | 0.6% | 10.5% |
| 2001 | 9.1% | -8.9% | 0.2% |
| 2000 | 9.7% | -17.5% | -7.8% |
| 1999 | 7.5% | -2.2% | 5.3% |
| 1998 | 7.9% | -3.6% | 4.2% |
| 1997 | 8.1% | 6.4% | 14.5% |
| 1996 | 8.7% | 7.7% | 16.4% |
| 1995 | 9.8% | 11.1% | 20.9% |
| 1994 | 8.7% | -2.1% | 6.7% |
| 1993* | 4.0% | 4.5% | 8.5% |
| **Annualized Since Inception** | **8.8%** | **1.4%** | **10.2%** |

* Fund Inception was June 30, 1993. Not a full year of return data.

| | Annualized Return Since June 1993 |
|---|---|
| **DK Income Fund** | **10.2%** |
| Merrill Lynch Government Bond Index | 6.4% |
| TSX Composite | 8.0% |

During the first quarter of 2016 the DK Income Fund generated income earned of 1.5% (roughly 6% annualized). This is temporarily below the lower end of our long-term band. We reported in our December 31, 2015 quarterly that we had 6 bond issues mature or called in the latter part of last year. This temporarily boosted our cash holdings to roughly 25% of the Fund by year end, and reduced income earned.

Bond prices declined (yields and income earned increased) towards year end and into the first two months of 2016. In February we began to deploy the available cash and by quarter end the cash balance was down to 10% of the portfolio. As of March 31st, the estimated income going forward is back above 7% annualized, and will continue to rise as we deploy the remaining cash.

During the quarter we added to some of our existing positions.

We added to our investment in **DirectCash Payments Inc.** by purchasing 8.125% bonds due August 2019 at $98.75, a yield of 8.6%. DirectCash is a leading global provider of ATMs, with the #1 market share in both Canada and Australia and the 3rd largest independent deployer of ATMs in the U.K. The Canadian market is currently well-served; however, growth should come from both Australia and the U.K. whose markets are relatively unsaturated. DirectCash has debt outstanding of $210 million and a current market cap of $215 million, of which management owns 30%. DirectCash has stable, recurring revenue streams with a proven track record of growing cash flows.

We continued to build our position in **GardaWorld Corporation** 7.25% bonds due November 2021 with an average cost of $82.00, or a yield of 11.7%. Garda is one of the world's fastest-growing security companies providing services at airports, sporting events, and office buildings. Garda is the North American leader in cash service solutions, including armored transportation. Bonds traded down as cash flows were impacted by integration costs of the acquisition of Aegis Group, a leading provider of protective services in Africa and the Middle East. These costs are largely behind them and cash flows should continue to grow organically, further securing our debt.

We added to our holding in **Gateway Casinos & Entertainment Limited** at $93.75 or a yield of 10.2%. Gateway is the largest casino operator in Canada with the majority of their assets in BC. Gateway has high barriers to entry, hard assets, and a predictable income stream to service interest and gradually reduce debt. Our bonds pay an 8.5% coupon and mature in November 2020.

We continued to add to our holding in **Newalta Corp.** at an average yield of 12.9% (7.75% coupon due in 2019 at $73.25 and 5.875% coupon due in 2021 at $84.75). Newalta is the 3rd largest landfill and waste management company in Canada with a market share of 15%. Newalta's business is heavily dependent on the oil and gas industry. Newalta strengthened their balance sheet, with the sale of the non-core industrial waste division for $300 million last year and a $50mn equity raise in March, putting them in a strong financial position until oil prices recover and activity returns. In the meantime, they are generating cash to service their debt with no major debt issues maturing until November 2019.

In January, we added to **Paramount Resources Ltd.** bonds (7.625% coupon due in 2019 at $69.25 and 6.875% coupon due in 2023 at $64). The average yield of our Paramount position at March 31st is 13.1%. Over the last two years, Paramount grew production from 20,000 to 50,000 boepd. To transport and process the increased production, Paramount elected to invest heavily in infrastructure.

The decline in oil and natural gas prices over the past 2 years has put pressure on Paramount's balance sheet. However, our analysis showed that the debt was covered by a strong asset base. On March 17th, Paramount announced the infrastructure sale of its Musreau Deep Cut facility for cash proceeds of $556 million, substantially reducing debt. The remaining debt is supported by its low cost core production and remaining infrastructure assets.

In addition to adding to these existing positions, the new positions added were Cenovus Energy, Devon Energy, EnLink Midstream, Cascades Inc. and Quebecor Media.

In February, we bought two issues of **Cenovus Energy Inc.** bonds at an average yield of 8.2% (5.7% coupon due in 2019 at $86.25 and 4.45% coupon due in 2042 at $62.50). Prices on Cenovus bonds traded down over the last year along with the decline in the oil price. Despite this difficult environment, Cenovus has a strong balance sheet with $6.5 billion of debt outstanding, offset by $4 billion of cash plus tangible assets valued at $18.6 billion. The large cash position allows them to withstand a prolonged period of lower oil prices, while the tangible assets support our debt.

We bought two issues of **Devon Energy Corporation** bonds at an average yield of 7.75% (6.3% coupon due in 2019 at $95.75 and 3.25% coupon due in 2022 at $79.25). Similar to Cenovus, Devon bonds traded down along with the decline in oil price. Devon has $13 billion of debt outstanding and $3.5 billion of cash. Devon produces 571,000 barrels of oil equivalent per day. Recent asset sales would put the value of their producing assets at $20 billion. In addition, Devon has infrastructure assets including a pipeline and a majority ownership in EnLink Midstream, which combined have an estimated value of roughly $3 billion. Devon has ample liquidity, is prudently spending within cash flow and has assets to protect their debt.

As part of our due diligence on Devon, we evaluated their 50% holding in **EnLink Midstream**. EnLink has a network of gathering, processing, fractionation, transportation, and logistics assets throughout North America. They provide services to largely investment grade energy companies, including Devon, on fee based contracts providing stable cash flows. Despite the decline in oil and gas prices, their quarterly operating margins remained flat in 2015. The

Company has $3 billion in debt, ample liquidity of $1 billion and cash flows to service their interest. As a result, we purchased Enlink bonds at a yield of 7.5%.

We bought a position in **Cascades Inc.** (5.5% coupon due 2022, yield 6.2%). Cascades produces & markets packaging and tissue products in North America and Europe. Cascades has instituted cost reduction initiatives improving operations, leading to a record year of cash flow generation in 2015. With significant investments in modernizing their asset base we expect continued growth which will benefit the Company, and its debtholders.

Finally we invested in **Quebecor Media/Videotron** bonds at 5.8% yield. Quebecor Media/Videotron is a telecommunications operator offering cable, internet and telephone/mobile services. They are the leading cable provider in Quebec with a strong brand and stable cash flows to service its debt with no near term maturities.