December 31, 2014

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
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Rates of Return[1]

	3 Mths	1 Yr	3 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception June 1993
DK Income Fund	**-3.8%**	**4.1%**	**4.9%**	**7.3%**	**10.8%**	**10.6%**	**11.0%**	**10.9%**
ML CDN High Yield	-4.7%	0.9%	7.4%	7.8%	4.5%	4.0%		
ML USD High Yield	-1.1%	2.5%	8.4%	8.9%	7.6%	7.3%	7.9%	7.6%
FTSE TMX Canada Universe Bond Index	2.7%	8.8%	3.7%	5.4%	5.3%	6.3%	7.2%	6.9%

High yield indices in Canada and the U.S. provided returns for 2014 of 0.9% and 2.5%, respectively. The Deans Knight Income Fund provided a higher return in 2014 of 4.1%. Investor thirst for income has driven down yields on all bonds; government, investment grade and high yield. As a result, investors continue to earn lower income returns without any reduction in risk. We take a more flexible approach. We chose to reduce our exposure to high yield bonds, currently less than 60%, and invest in private debt financings and dividend paying equities. This decision led to higher returns than the high yield indices in 2014 and, more importantly, provided superior returns over the last twenty years.

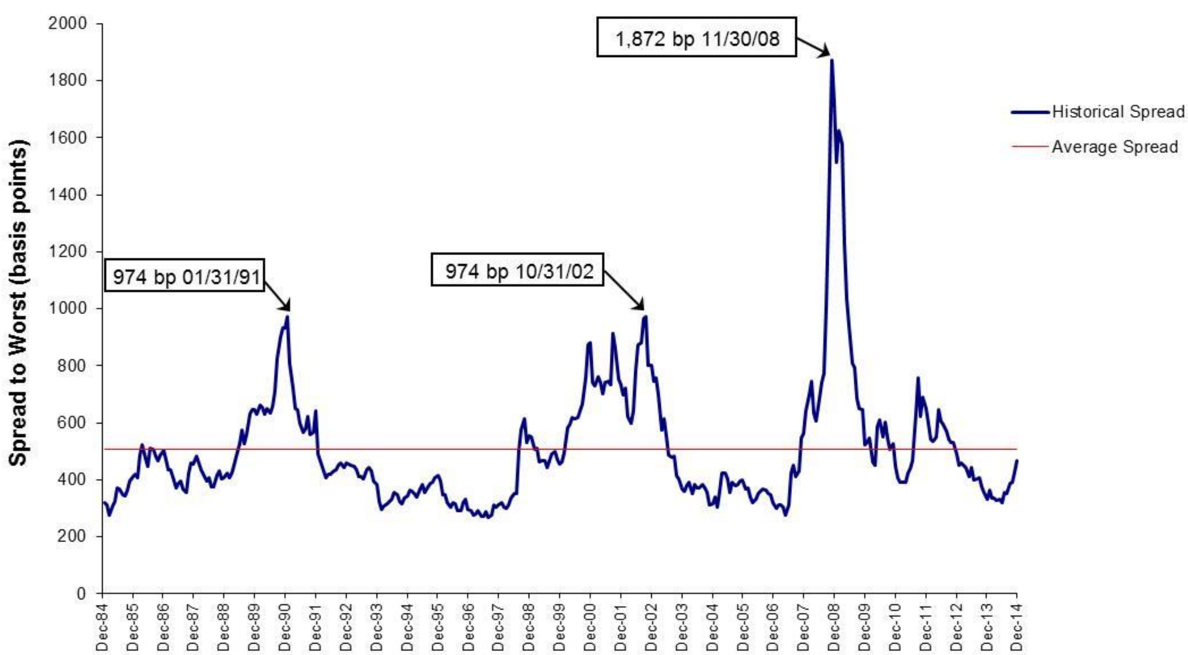
Looking at high yield indices more closely, the modest returns in 2014 were largely a result of price declines on oil & gas company bonds, which were down over 13%. The growth in global oil production over the past 5 years has come largely from U.S. shale production, financed by cheap debt. Many oil & gas companies are over-levered, and with current oil prices their business models are unsustainable. We own debt of Canadian oil & gas companies with strong management teams, substantial assets and cash flows which can support a reasonable amount of debt.

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

The fall in oil & gas bonds sparked a minor market sell-off with most non-resource sectors experiencing a slight pullback. High yield is still more attractive than government and investment grade bonds, which provide virtually NO yield. However, a further sell-off would be welcome as credit spreads remain below the long term average (see graph below). We own less than 60% in high yield bonds and we will have cash from near term maturities and a sale to an announced takeover. As a result, our portfolio is well positioned to take advantage as opportunities arise.

Credit Spread History

Merrill Lynch US High Yield Master Index Less 10 year Treasury Yield



Source: Bank of America Merrill Lynch

One area where we continue to find attractive opportunities is in private debt securities. In low interest rate environments, we want to lend shorter, at positive real rates, against reasonable collateral. These are hard to find in public markets and why we look for opportunities falling outside of traditional debt investments. Private debt is one such opportunity, as we: typically require security; demand a short maturity (i.e. 18 months on average); and, negotiate a higher coupon. In most cases, we receive “equity kickers” in the form of warrants, convertible features, or royalties which can provide capital growth in addition to our income. During the quarter, we were very active in this area. We structured and invested in three new private debt investments, renewed one and added to an existing facility.

On November 5th, we structured a $12 million Secured Note ($3 million in the DK Income Fund) with **Syncordia Technologies & Healthcare Solutions, Inc.** Syncordia is a medical billing company looking to make acquisitions in a fragmented industry and improve the revenue cycle for its clients. The CEO, Michael Franks, successfully rolled up a number of small businesses in the non-emergency ambulatory transport industry. In the course of doing this, he identified an opportunity in medical billing as operators were not adept at navigating their way through the complicated claims process both at the government and insurance level. The medical billing industry itself is inefficient and Mike and his team identified areas, particularly through the development of software, to improve the revenue management cycle.

We are providing debt financing to help Syncordia make their first major acquisition, which is particularly attractive as the acquired company has a 14-year track record and has developed its own software which Syncordia can use in future acquisitions. The business they are acquiring has roughly $3 million in EBITDA and the purchase price of the business is $22 – $24 million, dependent on the company meeting performance covenants. Previous management had very good relationships with their two large customers but had never really developed a sales force. Syncordia’s team will bring their expertise to the business and grow it through an internal sales force, and by acquisitions.

In addition to the $12 million in Notes, the company has raised over $15.5 million in equity, with significant insider participation. Our Notes have security over the business, their IP, and any future acquisitions. The debt has a term of 3 years, paying a commitment fee of 2% and a coupon of 11%. In addition, noteholders receive 125 warrants per $1,000 of Notes with an exercise price of $2 per share, a 25% premium to the company’s concurrent equity raise.

On December 12th, we structured a $10 million Secured Convertible Debenture ($3.75 million in the DK Income Fund) with **1006903 BC Ltd.,** operating under the brand **ShoeMe,** a private online retailer. ShoeMe was founded by Roger Hardy, founder of Coastal Contacts. Roger, and his team, built Coastal Contacts from scratch in 2000, growing it to $225 million in sales. Since inception, Coastal raised equity proceeds, net of buybacks, of roughly $40 million. In May 2014, they sold the business to Essilor International for approximately $450 million. Following the sale, Roger became CEO of ShoeMe and brought over key members of his team from Coastal Contacts.

ShoeMe was operating solely in Canada for the past two years, growing revenues to $15 million (Roger Hardy was the founder and Chairman during this time). Earlier this year, management identified a Seattle based online retailer to purchase as a means to expand their business. The retailer, which had been around for over 25 years, had built an impressive online platform and logistics channel. Despite a strong “backbone”, previous management had neglected its sales team and was driving business through Amazon rather than building on their direct client base, defined as customers who purchased within the last year, which at one point was over 1.5 million people. ShoeMe raised $31.5 million in equity to purchase the company. Insiders provided the majority of this capital.

In November, the company agreed to acquire the online business of Brown Shoe Company, which operates under the URL www.shoes.com for $15 million. Brown will receive $7.5 million in cash and receive a subordinate convert of $7.5 million. Following both acquisitions, ShoeMe will have more than $200 million USD in annual sales, which management believes they can grow by tweaking the business model and employing similar sales practices to ones developed at Coastal Contacts.

The $10 million Secured Convert, ranking ahead of the Brown Shoe convert, will be used to fund the cash component of the acquisition and provide working capital to the business. The company is raising an additional $6 million in equity to fund growth in Canada, which brings the total equity capital raised to date of roughly $47.5 million, including the vendor note. The Deans Knight Convert has a term of less than 3 years, 10% coupon, 1% commitment fee and the conversion price will be set at a 30% **discount** to the $5 million equity raise.

We negotiated a $12 million Convertible Note ($1.35 million to the DK Income Fund) with **Conifex Timber Inc.** closing on December 15th. We have provided debt facilities to Conifex in the past which had been repaid. The company had a $10 million debt facility coming due and we helped refinance it at a 7% coupon and an attractive 15% premium to what we believe is a depressed price. The company has experienced operational issues, which caused the share price to decline. Despite the issues, Conifex has a strong asset base with three mills, a bio-energy facility and, most importantly, fibre supply in a market where supply is declining and demand is rising. At a conversion price of $6.22, we believe the company is undervalued and investors will benefit as operations improve and value is recognized by the market. Conifex shares closed the year at $6.44.

We rolled our $3 million 12% Promissory Note with **IVY Lending Company** ("IVY") into a $1 million 3 month Note at 15% and a $2 million 1-year Note at 12%. IVY is a single purpose lender established to underwrite loans for TitleMax Holdings, the largest automobile title lending company in the U.S. Our Promissory Notes is guaranteed by TitleMax and are secured by the assets of IVY (loans receivable and their underlying collateral). In the year we have been involved, IVY has grown its asset base with minimal growth in debt. We recently visited their head office in Savannah, Georgia to conduct further due diligence on the existing opportunities as well as others. We expect to continue the relationship with IVY and grow it over time.

We provided a portion of a $2.5 million add-on to a $5 million Senior Secured Note to **JDS Silver Inc.**, a private mining company. Our Note is secured by the equipment, with a conservative $9 million appraisal value, and mineral rights which the company acquired for $15 million. The company is awaiting a small mines permit, expected in early 2015. They will then look to finalize a $45 million term sheet with Goldman Sachs and raise up to $15 million in equity to repay our Note and provide working capital to get the mine in production. The Notes mature on December 6, 2015, and have a coupon of 12%, increasing to 14% on June 6th. If the Note is paid off early, the company will still owe us the remaining interest subject to a small discount.

In addition to private debt, we have also invested in dividend paying equities which have added to our long term performance. Our equity weight is actually declining as a result of takeover bids for our investments in **Contrans Group Inc.** and **Vicwest Inc**. These examples highlight our philosophy and how taking a long term view can lead to attractive returns.

In July, we received a takeover offer for our trucking company, Contrans. We have been involved as a shareholder of Contrans since 2007, adding to our position during the “great recession” in 2009. By early 2014, we, on behalf of our clients (both equity and income) represented 12% of the company’s shares, second only to the Founder/CEO Stan Dunford who owned approximately 15%. Stan, an ex-truck driver, built Woodstock, Ontario based Contrans into the second largest trucking company in Eastern Canada. The largest company in Canada, TransForce Inc., bid for Contrans at $14.60 per share, plus allowed Contrans to distribute a special $0.40 dividend to shareholders…net to us $15 per share. The transaction closed in November, providing the portfolio with roughly 3% in cash.

On November 11th, Vicwest Corp, an investment with us for 15 years, agreed to be acquired for $12.70 per share. Vicwest is a leader in grain storage/handling systems and building construction products. We had originally owned the debt. However, in 2001 the company filed for CCAA protection as Vicwest, operating in two cyclical businesses, was facing a number of headwinds that impacted its short term cash flows. We got heavily involved in the restructuring process and our bonds were exchanged for equity, which began paying a dividend in July 2005. We have received more than $12 per share in dividends and the $12.70 sale price is three times our original cost base of $4.13. Despite the bankruptcy or, more accurately, because of the bankruptcy, Vicwest has been one of our best investments in over twenty years.

While we have already reinvested the cash from our Contrans sale in some of the above mentioned private debt financings, cash from Vicwest, expected in early 2015, will be invested in our best opportunities; whether they be high yield, private debt or dividend paying equity.