

**THE COMPANY**

Shermag Incorporated is a residential furniture manufacturer and distributor that is headquartered in Sherbrooke, Quebec. The Company sells its mid to high end furniture through major department stores, large independent furniture dealers, North American mass-market chains and smaller independent boutiques. Shermag is unique in that it has a vertically integrated production chain that encompasses timber cutting rights, three sawmills, a veneer plant and several manufacturing facilities. This network of medium sized factories allows the flexibility needed to meet customer demands in an efficient and cost-effective manner. While Shermag is a Canadian company, approximately 80% of its sales are to the United States.

**FINANCIAL DATA**

	2002	2003	2004
Earnings per Share (\$)	0.54	1.20	1.27
Price to Earnings (times)	18.5	8.3	7.9
Dividend (\$)	-	-	-
Dividend Yield (%)	-	-	-
Book Value (\$)	7.34	8.42	9.72
Price to Book Value (times)	1.36	1.19	1.03

**HISTORICAL SHARE PRICES**

**WHY ABC FUNDS BOUGHT SHERMAG**

Like many cyclical consumer, industrial product and building material companies, Shermag's share price has declined from its high of approximately \$18.00 in 1998 to a recent low around \$6.50. This was primarily due to a series of interest rate hikes and the ensuing economic uncertainty. Meanwhile, and unlike many such companies, Shermag has shown excellent financial performance and has continued to build its order backlog. In fact, Shermag's main challenges have been to manage the Company's rapid growth and ensure sufficient production capacity to meet customer demand. As value investors, we are compelled to identify companies with strong fundamentals that have been overlooked by the market. Because Shermag's decline was not related to any company specific issues, we believe that once the economic outlook becomes less uncertain the stock will return to historic valuation levels.

Shermag's financial performance has been exceptional and belies the "old-economy" nature of furniture production. The Company has shown five-year revenue growth at a compound rate of 22.6%, five-year net earnings growth at a compound rate of 31.7% and five-year shareholders' equity growth at a compound rate of 52.3%. Return on shareholders' equity has averaged approximately 26% over the past five years and debt repayments have reduced the long-term debt to equity ratio from 0.93 in 1996 to 0.16 in 2000. Earnings in fiscal 2000 were \$0.84 per share and we expect the Company to earn \$1.00 per share in fiscal 2001. Despite its tremendous growth profile, Shermag currently trades at less than 8 times earnings and close to its book value of \$6.50 per share. However, we estimate that Shermag's net asset value (NAV) is in the \$8 to \$10 range because certain assets, including forestry properties, have been recorded under accounting standards that fail to recognize tangible or realizable value.

Under the leadership of Jeff Casselman, appointed President and CEO in August 2000, Shermag has placed a greater emphasis on articulating its business model. With 80% of sales to the United States, Shermag's operational performance is closely tied to the U.S. housing market, the renovations market and consumer demand for contemporary-style furniture. In addition to vertical integration, management has simplified operations by reducing the number of collections and colours that are offered each year. Management's stated goals are to ensure the stability to pursue growth opportunities, to improve productivity and efficiency and to synchronize operations to maximize the benefits of the vertically integrated production chain. Attainment of these objectives should provide for greater corporate profitability and investor visibility. Though management does own stock in the company, their 15% stake, approximately, does not preclude the possibility of an opportunistic takeover.

Many economically sensitive stocks have been in decline since 1998. However, select companies have been able to consistently report improving business fundamentals irrespective of disappointing share price performance. Shermag is one such company whose share price simply does not reflect its balance sheet strength, its excellent financial performance and its tremendous return on shareholders' equity. Because the mid to high end retail market is less affected by fluctuations in the economic cycle, we look for both revenue and earnings growth to continue. However, we expect that the shares will outperform once the broader economic outlook becomes more favourable. Our value investing discipline ensures that we have our positions before an economic recovery stimulates widespread buying interest in cyclical companies.

## UPDATES

Shermag has reported results for the first nine months of its fiscal year that were generally in line with the Company's expectations. Though revenue growth slowed over the nine-month period, sales of \$121 million were still up 7% from the corresponding period last year. Earnings growth continued at a pace consistent with past performance as earnings per share grew 25% from \$0.60 to \$0.75. To alleviate any fears related to the ailing economy, management stated that "with the data we have now, the outlook for the final quarter is optimistic." These results were well received by the market and the stock has performed strongly since April.

Shermag has also recently released two interesting pieces of news. Unfortunately, a labour dispute with a small group of employees at the Company's furniture plant in Disraeli, Quebec resulted in a temporary production stoppage. Negotiations are continuing and the matter will hopefully be solved before further disruptions occur. On a more positive note, Shermag has received the Vendor Excellence Award from Marshall Field's for exceptional performance in 2000. Marshall Field's is one of the top retailers in the United States and has over 64 department stores in eight states. The distinction recognizes the Company's superior merchandising, logistics and vendor relationship management, which are critical factors required for long-term success.

ABC Funds  
June 15, 2001

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Shermag, the Quebec-based residential furniture manufacturer, has been quite volatile in recent months as investors reacted to several important news releases. On July 19, Shermag announced the intention to take a charge in the first quarter ended June 29 related to the bankruptcy of HomeLife, an American furniture retailer. HomeLife had been a concern for several months and, though Shermag was able to reduce its exposure, the Company was unable to collect a significant portion of a \$2.1 million (U.S.) receivable from this major customer. When Shermag's first quarter results were released on August 22, the HomeLife charge and the now-resolved labour dispute at the Disraeli facility resulted in flat revenue growth and approximately breakeven earnings. However, if we eliminate these one-time events, Shermag would have reported year over year revenue growth and in-line earnings. According to Jeff Casselman, President and CEO, the Company "continues to overcome the significant downward trend which has affected the demand for consumer products in the United States."

Despite these difficulties, we believe that Shermag is performing reasonably well and has the financial flexibility to capitalize on any potential business opportunities. New initiatives to stimulate growth include a focused effort on the independent furniture store distribution channel in the United States. Also, Shermag is establishing a division to import finished furniture from Asia, where intricate designs with intensive labour requirements can be manufactured in a more cost-effective manner. Although the U.S. economy remains under pressure, management is confident that they will not lose any market share and can return to prior levels of growth and profitability. From a medium to long-term perspective our positive outlook for the stock remains unchanged.

ABC Funds  
August 31, 2001

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With the sharp drop in consumer confidence, weak results have been expected from the retail and consumer products sectors, including furniture manufacturers such as Shermag. However, the Company recently reported decent results and showed sales growth of approximately 6%, year over year. This was primarily due to its positioning as the price-leader in the higher-end segment of the market. Essentially, Shermag supplies "the lowest-cost product in the very best stores" and is therefore less sensitive than others to an economic downturn.

Admittedly, margin erosion offset revenue growth, as earnings per share fell to \$0.15 from \$0.24 in the comparable quarter last year. Specifically, the Nadeau division struggled to maintain operating efficiency as new collections were launched to compensate for the loss of business after the HomeLife bankruptcy. Management has reported that the Nadeau plant is back at 90% efficiency, which should be evident in the coming quarters. Jeff Casselman, President and CEO, has made it clear that he intends to focus on aggressive cost reduction in order to support margins and return to previous levels of profitability.

Signs that the worst is past are already apparent, as November sales are flat thus far after declines of 22% in October and 30% in September. The long-term fundamentals of the business are healthy and the order backlog remains a robust \$17 million versus \$19 million last year. Finally, Shermag's tangible book value of \$6.95 should provide a solid support level for the stock. We believe that management has a good handle on the business and will successfully weather this trough period.

ABC Funds  
November 30, 2001

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Since we last updated our Shermag commentary, the Company has been one of our best performing Value Favourites. Essentially, strength in the housing market has had a trickle-down effect and many related industries, including furniture manufacturers, have benefited. In fact, the most recent Canadian GDP report indicated that furniture retailers and wholesalers have expanded output by 3.1% in February alone. Although the Company has yet to report results for the first three months of the calendar year, several American and Canadian competitors have shown good sales growth and improving financials in the comparable period, which bodes well for Shermag.

## UPDATES (cont'd)

We believe that Jeff Casselman has done an excellent job guiding the Company through a very difficult period and the stock has responded. However, at current valuation levels the bulk of the recovery is now built into the share price. We will monitor the situation closely in anticipation of the Q4 and fiscal year financial results to be released June 19, 2002.

ABC Funds  
May 3, 2002

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Shermag, a residential furniture manufacturer, will also benefit from strength in the housing sector. On June 21, the Company reported its fiscal 2002 results and succeeded in maintaining year over year sales growth despite one of the worst years in the furniture sector in recent memory. Gross revenue totaled \$165.7 million compared to \$164.9 million a year ago and net earnings were \$7.2 million or \$0.54 per share compared to \$13.3 million or \$1.00 per share in fiscal 2001. Cash flow from operating activities amounted to \$24.4 million, which was used to reduce bank loans and acceptances by \$14.4 million and long-term debt by \$1.4 million. Because of the time lag between the housing and furniture retailing cycles, we believe that Shermag will be able to generate good earnings momentum going forward. Future growth will come from the launch of several new collections, the new import division and the potential to expand across regional store chains and independent furniture stores.

ABC Funds  
August 9, 2002

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Over the course of the past two years or so, the economy and the housing sector have shown a pronounced disconnect. Economic malaise, especially in the United States, has led to a period of monetary easing and record low interest rates. This in turn has led to a surge in new and existing home sales. Shermag illustrates this dichotomy quite nicely, because although the consumer has been hesitant to spend freely, the strength of the housing sector has created good demand for residential furniture.

For the first half of fiscal 2003, Shermag reported gross revenue of \$90.7 million, an increase of 20% from \$75.3 million last year. Despite a difficult pricing environment, the Company has had good success with the independent furniture store channel and with the new line of imported, traditionally styled furniture. Operationally, management continues to do a great job. Gross margins improved from 27.2% to 27.7% for the first half of the fiscal year. Selling and administrative expenses as a percentage of sales declined from 16.1% to 12.1%. Also, interest costs declined significantly due to a reduction in net debt, which has fallen to just \$4 million from \$13.6 million at the beginning of the year. Revenue growth and margin improvement translated into fully diluted earnings per share of \$0.51 for the first six months of fiscal 2003 compared to \$0.16 last year.

As we have said before, we are extremely impressed with Shermag's progress over the past year and a half. Jeff Casselman and his team have done a great job turning around the Company's operations amid a very difficult macro-environment. However, the stock has declined from a high of \$15 in May as investors became nervous about the resiliency of the consumer and the sustainability of housing demand. This correction seems to have played out and we now expect that investors will focus on Shermag's ability to continue to show good earnings growth.

ABC Funds  
January 3, 2003

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Last week, Shermag reported excellent results for the fourth quarter and fiscal year ended April 4, 2003. Gross revenue increased 16% for the quarter to \$53.8 million and 18% for the year to \$195.5 million. Diluted earnings per share increased 68% for the quarter to \$0.37 from \$0.22 and 122% for the year to \$1.20 from \$0.54. Management was able to grow the bottom line faster than the top line by achieving operational efficiencies at the factory level, reducing selling and administrative expenses and paying down debt, thus eliminating interest expenses. Comparing fiscal 2003 to fiscal 2002, the gross margin improved to 28.8% from 27.2%, the EBITDA margin improved to 16.0% from 12.6% and the net margin improved to 8.3% from 4.3%.

Although the retail environment remains difficult, Shermag has outperformed many of its peers. Many of Shermag's customers have reported flat or declining sales while Shermag has experienced new order growth of between 4% and 10% each month, since the beginning of the year. Further, the Company's plan to develop the independent retail store distribution channel is showing great promise. Revenue from sales to independents grew 32%, well above the 18% revenue growth rate recorded for the Company as a whole.

Shermag is now in a net cash position, having paid off all interest bearing debt with cash generated from operations. Because of the solid balance sheet, Shermag was able to acquire Jaymar Furniture Company, a Quebec-based manufacturer of leather and fabric upholstered furniture. The acquisition closed May 16, 2003 and is expected to be immediately accretive to Shermag's profitability. The move is strategically astute and will allow Shermag to offer a more complete product line through its existing distribution network. Going forward, we look for greater penetration of the independent retail channel, continued progress with the imported traditionally styled product line and perhaps even some additional tuck-in acquisitions.

ABC Funds  
June 27, 2003

## UPDATES (cont'd)

Shermag, one of our long-time holdings, has reported six consecutive quarters of year over year earnings growth and has beaten expectations for the first two quarters of fiscal 2004. In the first quarter of fiscal 2004, fully diluted earnings increased 40% to \$0.35 from \$0.25 per share. The Company then earned \$0.34 per fully diluted share in the second quarter of fiscal 2004, an increase of 31% from the \$0.26 earned in comparable period the previous year. Operational improvements, increased penetration of the independent retail store channel and resilient consumer spending were credited for the solid results.

Turning our attention to the balance sheet, long-term debt increased to \$48.5 million with the acquisition of Jaymar Furniture Company in the first quarter of fiscal 2004. However, operations generated \$6.6 million of cash in the second quarter, \$4.4 million of which was used to reduce bank debt. Even after the Jaymar acquisition, the balance sheet remains conservatively capitalized with a 0.3 net debt to equity ratio. We believe that management has done a solid job for its shareholders over the past two years, having grown book value at a CAGR of 15% to reach \$9.26 per share.

Looking forward, Shermag must cope with the impact of the strengthening Canadian dollar with more than 70% of the Company's sales to the United States. Currency hedges are presently in place, but they offer declining protection over the next two years. Management expects to rely on cost reduction initiatives in order to remain competitive in Canadian dollar terms. Despite this challenging issue, management stressed that the key to their business is to get their products to the showroom floor and into the hands of customers. A recovering U.S. economy and well-received collections at the recent High Point furniture show should allow Shermag to extend its track record of success.

ABC Funds  
November 28, 2003

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Despite aggressive cost control and a currency-hedging program, Shermag was forced to issue revised earnings guidance on January 26. Shermag, like many Canadian manufacturers, is suffering from the effects of a stronger Canadian dollar. Revenue is expected to be flat in Canadian dollar terms compared to last year, since Shermag declined to raise prices in order to protect market share. The Company stated that earnings would be below consensus estimates and would be in the range of \$0.22 to \$0.28 per share compared to \$0.32 per share last year. We continue to believe in Shermag's business model and the Company's management, who even took the initiative to reduce salaries and bonuses as a result of the disappointing earnings guidance.

ABC Funds  
January 30, 2004

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Shermag, like many other Canadian manufacturers, has been hit by fears of a rising Canadian dollar. Faced with a difficult situation, management made the strategic decision to protect its hard-won share of the competitive US market. The Company refused to raise its prices, which led to lower Canadian dollar dominated revenues. This in turn compressed margins, despite a foreign currency hedging program and aggressive cost containment. As we know, Shermag was forced to revise its earnings guidance on January 26 of this year and the Company's shares subsequently declined below \$12 before stabilizing around the \$13 level.

When Shermag released its results on February 20, we were able to get a more complete picture of the Company's financial health. For the third quarter of the current fiscal year, the Company earned \$0.26 per share compared to \$0.32 per share last year. For the first nine months, Shermag earned \$0.96 per share and seems on track to earn between \$1.20 and \$1.30 per share for the year. Shermag's operating activities have generated \$7.1 million in cash flow over the first nine months of the current fiscal year despite consuming \$400,000 in the third quarter. The balance sheet remains conservatively capitalized, with a debt to equity ratio of only 0.3 times.

We believe that the mid to long-term outlook for the Company remains strong. Record low interest rates have fuelled a housing boom that in turn has driven furniture sales. In fact, retail furniture sales have been increasing steadily since February of 2003, according to the US Department of Commerce's Advance Monthly Sales for Retail Trade and Food Services Report. We look for this trend to continue for some time, since furniture sales generally lag new home sales by several months. We believe that if the stock continues to trade at only 10 times forward earnings, the Company will use its cash flow to buy back stock, pay a small dividend or make another small but accretive acquisition.

ABC Funds  
April 4, 2004

## UPDATES (cont'd)

This past week Shermag reported first quarter results for the period ended July 2, 2004. Unfortunately, the results were negatively impacted by three key factors: a weaker \$US, labour disruptions at three manufacturing facilities and competitive business conditions. Revenue declined 14% to \$50.2 million in the current quarter from \$58.5 million a year ago. Gross profit fell to \$10.8 million from \$17.8 million. Of the \$7 million decline in gross profit, \$2.5 million was related to foreign exchange movements, \$3 million was related to the labour dispute and the remaining \$1.5 million was related to the competitive environment. Earnings per share declined to \$0.04, which was consistent with the Company's guidance released on July 30th.

Despite the setback in the quarter, the Company is hard at work dealing with the three not-unrelated issues noted above. As background, strikes began at three manufacturing facilities in April and temporarily limited shipments. Workers at the Granby plant returned to work in mid-June but employees at the Victoriaville and Disraeli plants remain off the job. Thankfully, the Company responded as quickly as possible to reallocate production and there is a more normal flow of products today. The labour issues stem from the Company's need for greater flexibility from its workforce, which is required to produce the custom or personalized pieces demanded by customers. Being able to offer unique furniture is a competitive advantage that should help to protect the Company's market share and offset a weaker \$US.

It is interesting to note the implications of the work stoppages. Shermag was already producing some furniture in Asia and the strikes "accelerated the learning curve" as more production was shifted overseas. In the Company's press release President and CEO Jeff Casselman noted, "it was also confirmed that the majority of the domestic production of the products transferred to Asia would not be repatriated and that the resulting overcapacity would necessitate a significant reduction at one or both of the strike-bound facilities". However, he made it quite clear that it would be a mistake to entirely abandon production in North America. Although the cost of labour is more expensive here, the ability to quickly produce personalized or customized pieces is a key selling feature. We will look for additional information on the Company's plans over the next few months.

Looking past the short-term issues, the Company is bullish on mid to long-term furniture demand. The recent housing boom and demographic trends, such as the aging population with higher disposable income, bode well for the industry. With the stock trading close to its book value of approximately \$10, we believe that the stock has been oversold based on short-term, temporary factors. The Company is expected to report better results over the back half of the year as the impact of the labour disruptions diminishes.

ABC Funds  
August 13, 2004

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Shermag has just reported financial results for the third quarter and nine months ended December 31, 2005. As we know, the results have been under pressure from a weaker US dollar, labour disruptions and competition from Asian. However, we believe that management is doing all they can to mitigate these issues. The strikes have been resolved and the Company has been working to reduce the backlog and inventory that built up during the disruptions.

In the quarter, gross revenue was \$67.6 million, an increase of \$8 million or 13.3% from the comparable quarter last year. The magnitude of the impact of the weaker US dollar was significant. Sales to the United States in US dollars rose 25.7%, however sales increased only 10.5% in Canadian dollar terms. In Canada, sales increased 19.6% to \$20.7 million. Net earnings were \$2.3 million or \$0.17 per fully diluted share compared to \$3.5 million or \$0.26 per fully diluted share. These results are within the Company's revised guidance that was issued January 31, 2005.

In the press release, management spent a lot of time discussing their strategy to remain competitive. Notably, the Company is building a new development centre in Sherbrooke, Quebec. Management believes that the focus on reducing time-to-market of desirable and personalized products will be the key to renewed commercial success. The manufacturing process will become more dynamic and flexible, which will allow for more choice and customization. To complement the operational changes, the management structure will become more centralized. Planning, marketing and logistics functions will all be consolidated at the corporate level to ensure better customer service and inventory control. We look forward to watching how these initiatives play out over the coming quarters.

Despite the difficult environment, Shermag's book value has grown to just over \$10 per share, implying a price to book multiple of approximately 0.7 times. In fact, the stock is now trading below the Company's tangible book value of \$7.76 per share. For a Company that has traditionally generated more than \$1.00 per share of free cash flow and continues to earn a profit during one of the most difficult periods we have ever seen for a Canadian based manufacturer/exporter, the valuation is simply too cheap. The longer the valuation remains depressed, a privatization or a takeout by a financial buyer becomes more likely.

ABC Funds  
February 11, 2005

## UPDATES (cont'd)

After a long slide, Shermag's stock has fallen off a cliff in recent days on large volume. At the request of the Toronto Stock Exchange, the Company put out a press release stating that "there have been no material corporate developments since it released its first quarter results on August 11, 2005". The trading pattern indicates one of two things. Either there has been a change in personnel at a fund company and the new portfolio manager has blown out the stock or somebody has lost their nerve and puked out his or her position. In either case they have dumped stock with a complete disregard to price.

When things get dodgy, the first thing you must do is reassure yourself that the balance sheet is stable. Shermag has net debt of \$26 million, and a net debt to capital ratio of 18%. On a trailing 12 month basis, cash flow from operations covers interest expense 5 times over and EBITDA covers interest expense 7.5 times. Given these metrics, we don't believe that the Company is facing any liquidity or solvency issues.

So how cheap did the stock get? Today Shermag has a book value of \$8.90, a tangible book value of \$7.40, working capital per share of \$5.60 and, incredibly, net working capital of \$3.20 per share. At the bottom of the sell-off, anybody with cash could have bought the entire Company for approximately \$32 million, closed it, sold everything at book value and made a profit of almost \$11 million. Who said the capital markets are efficient?

ABC Funds  
September 30, 2005

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Unfortunately, after almost six years, we have sold our entire position in Shermag Incorporated at a loss. Over the course of our holding period, we watched management make tremendous strides with the business, which were undone by two key factors. First, the Canadian dollar appreciated from \$0.67 per US dollar to \$0.90 per US dollar. With exports accounting for approximately 70% of sales, the swing in the currency just crushed the Company's margins. Second, as the quality of lower-cost Asian manufacturers improved, competition became fierce. Consumers were unwilling to pay a premium for North American-made products anymore.

In response, management attempted to transform the business by manufacturing standard pieces in Asia and customizable pieces in North America. This retooling has taken much longer and has been much more difficult than we had imagined. Strikes, layoffs, facility closures and write-downs all had a detrimental impact on the financial results. It is unknown how long the turnaround will take or whether more facility rationalization will be needed. We believe that investors simply became fatigued with the whole process.

Looking at the Company's valuation, there is no doubt that Shermag is inexpensive based on the balance sheet. In fact, the stock trades below the Company's net working capital, a proxy for the liquidation value of the business. Investors must not believe that inventory can be sold for cost or estimated net realizable value or that the accounts receivable can be collected in full. We had expected the stock to strengthen with the signing of a new credit agreement on June 12. Wachovia Finance provided a term loan for up to \$10 million and a revolving credit facility of \$55 million. However, subsequent results were so disappointing that investors continued to avoid the stock.

When we learned that someone was looking for a relatively large amount of stock, we were forced to examine our options. We were reasonably certain that the stock was going to either an activist investor or a financial buyer, but we had not seen this type of demand for almost 12 full months. Our Shermag position had been diluted down in our portfolio such that even if it doubled, it had no meaningful impact on the performance results. We also needed to offset some capital gains in our portfolio that we had accumulated over the course of the year. We eventually came to the difficult conclusion that it was better to take advantage of the demand today rather than wait for the potential upside of a turnaround with an unknown time horizon.

Our suspicions were proven correct when on August 22 Clarke Inc. announced that it had acquired 1,555,000 common shares of Shermag, or 11.65% of the outstanding shares. Clarke Inc. is known for acquiring troubled companies, injecting capital, paring down debt and patiently awaiting a turnaround. However, given our risk tolerance, we believed that it was time to take advantage of the near-term demand and reallocate our capital to other opportunities.

ABC Funds  
August 25, 2006