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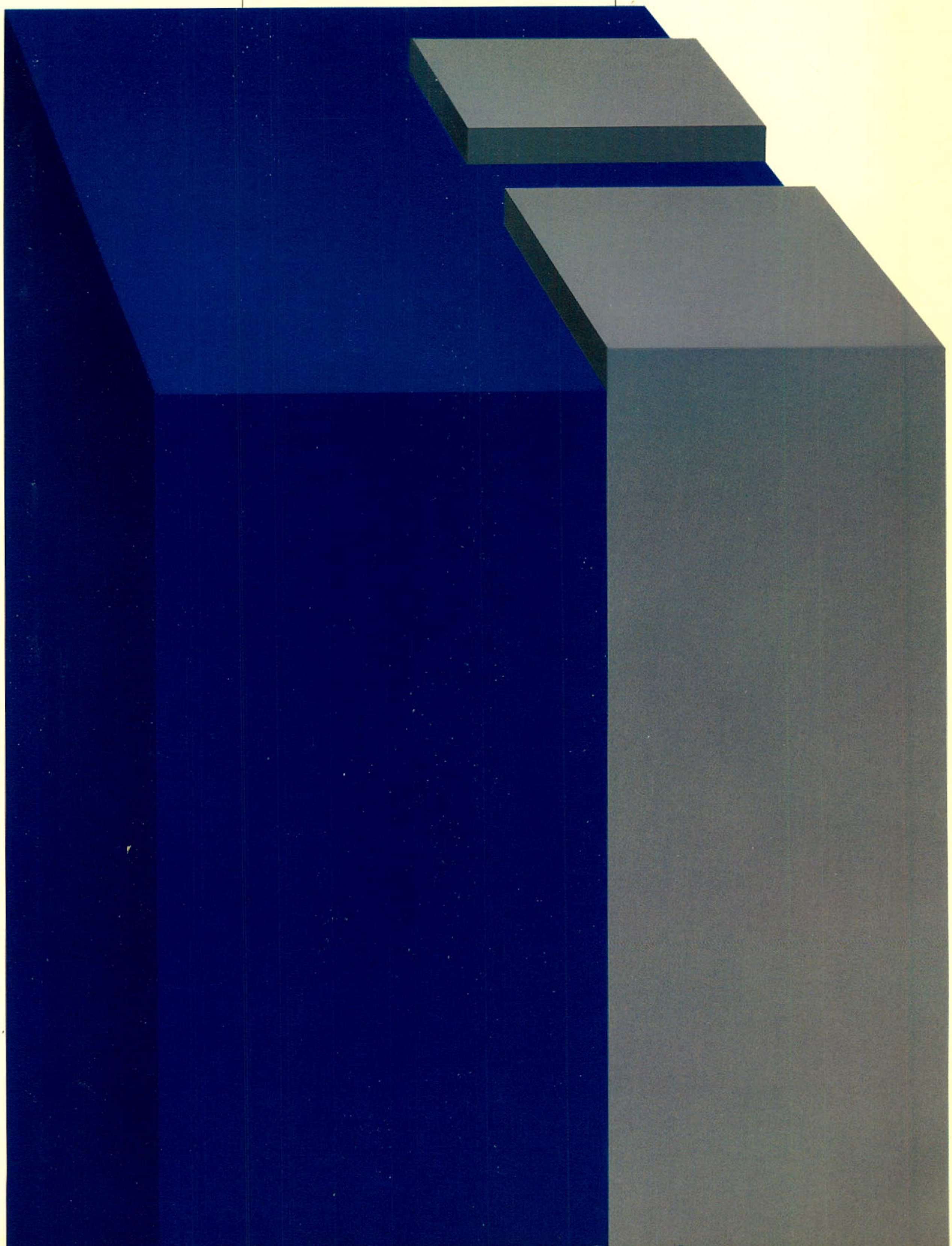
FEDERAL INDUSTRIES

1985
ANNUAL
REPORT



Contents

FEDERAL INDUSTRIES LTD.

Federal Industries is a diversified management company, headquartered in Winnipeg, Canada. Through its operating Groups, Federal is involved in transportation, aerospace and industrial distribution in North America and internationally.

The Company has assets in excess of $528 million, and annual sales of $719 million. A program of ambitious, but prudent, future growth is set out in the Company's Corporate Long Range Plan which is available on request.

The majority of the Common and Preferred Shares outstanding are owned by residents of Canada. Shares are traded on the Toronto and Winnipeg Stock Exchanges.

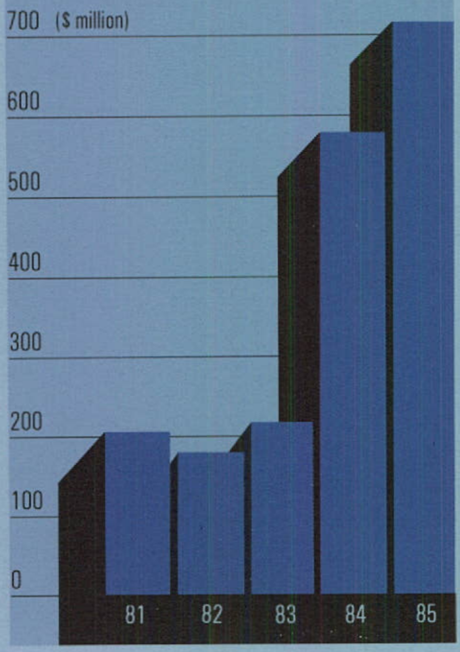
ANNUAL MEETING

The Annual Meeting of the Shareholders will be held at the Westin Hotel, Two Lombard Place, Winnipeg, Manitoba, on May 8, 1986, at 4:30 p.m.

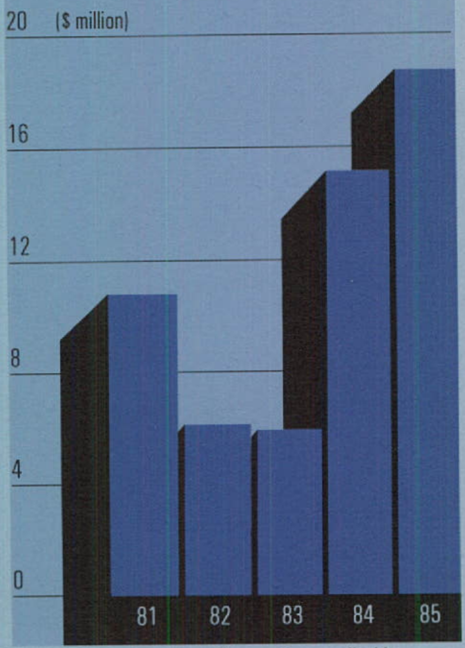
FEDERAL INDUSTRIES

For the year ended December 31 ($ million)	1985	1984	1983
Sales	719.0	572.6	203.8
Earnings before interest, taxes, and extraordinary item	49.5	43.4	20.2
Interest charges	18.6	17.5	8.8
Net income *(before extraordinary item)*	18.0	15.2	5.9
Cash flow from operations	34.5	24.0	12.5
Working capital	164.4	137.4	126.5
Total assets	528.9	449.7	377.0
Earnings per Common Share *(before extraordinary item)*	$1.17	$0.99	$0.51
Equity per Common Share	$8.94	$7.55	$8.01
Return on common equity	16.2%	12.4%	7.1%
Common Shares outstanding	14,557,967	11,831,158	11,774,422

ACQUISITIONS AND INTERNAL GROWTH INCREASED SALES BY 25%.



NET EARNINGS GREW BY 18% – SETTING A NEW COMPANY HIGH.



Before extraordinary items, where applicable.

THE REPORT TO SHAREHOLDERS

1985

WAS ANOTHER SUCCESSFUL YEAR FOR FEDERAL INDUSTRIES, WITH INCREASES IN ALL KEY FINANCIAL INDICATORS, INCLUDING SALES, PROFITS AND RETURN ON EQUITY.

On the strength of both acquisitions and internal growth, 1985 sales once again set a record — totalling $719 million, up more than 25% from 1984.

Net earnings for the year before extraordinary items grew over 18% to $18 million, also a new high for the Company.

On a per share basis, earnings before extraordinary item were $1.17 versus 99 cents in the previous year, with fully diluted at $1.05 compared to 92 cents in 1984. Per share numbers reflect a two-for-one stock split during the year.

In 1984, the Company took an extraordinary, non-cash writedown of its investment in the White Pass railway aggregating $15.2 million, reducing final earnings in that year to a loss of 30¢ per share.

Return on common equity continued its improving trend to 16.2%, above the long range minimum threshold of 15%. All of the operating groups contributed towards this achievement through plans and strategies designed to increase profitability while protecting the shareholders' investment.

Key developments during the year include:

- Acquisition by Canadian Motorways of Direct Transportation System balanced our national freight hauling services and significantly lowered fixed costs as a percent of revenue. The result is a large, profitable, less-than-truckload carrier, well positioned in its markets to take advantage of the changes to come as the industry deregulates.
- Opening of Standard Aero (Western), the Aerospace Group's entry into large airframe maintenance, exploits a strategic opportunity spawned by deregulation of the commercial airline industry in the United States.
- Reorganization of aircraft engine overhaul and parts distribution into one unit, the Small Engine Division, has resulted in a lower cost base, improved marketing and enhanced margins. Important new product lines and the establishment of regional service centres in the United States will raise returns substantially.
- Acquisition early in 1986 by Russelsteel of Wisconsin-based I. Bahcall, a prominent, general-line steel distributor, marks the beginning of a service centre growth strategy for the United States.
- The development of excellence in management remains a key objective. During the year, the Company added a Vice President/Treasurer to the senior corporate team and attracted several outstanding managers to strengthen each of the operating Groups.
- In October, 1985, the Company raised over $25 million through a common share issue, recognizing the need to underpin the substantial asset growth and to prepare for future expansion.

Federal Industries is diversified by choice and is committed to managed expansion through a combination of internal growth and acquisition. Fiscal prudence dictates that the Company be financially prepared by raising or arranging appropriate funding — especially equity — in advance of requirements. An aggregate of over $50 million in cash and short term investments, together with $20 million in redundant assets held for resale and anticipated operational cash flow, is available for redeployment.

However, the current market for acquisitions is extremely competitive, and most prices do not reflect underlying value. Consequently, short-term profitability and return on equity are being adversely affected by relatively large cash reserves.

The balance of this Report provides a detailed assessment of performance for the year— and the Company's future prospects.

During the year, your Board of Directors was strengthened by the addition of four new members: J. Peter Gordon, Robert Stollery, Arni C. Thorsteinson, and Adam H. Zimmerman. The beneficial impact of their counsel is already being felt.

On behalf of the Board of Directors,

JFraser

John F. Fraser
President and Chief Executive Officer

Stewart A. Searle

Stewart A. Searle
Chairman of the Board

HOWARD ROSS LIBRARY OF MANAGEMENT
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McGILL UNIVERSITY

THE PRESIDENT'S REPORT

JOHN F. FRASER
President and Chief Executive Officer

As more new shareholders are attracted to Federal Industries, it's important to re-emphasize the long-term framework in which management approaches your Company's planning and development. This underlying long range orientation drives our planning, but we also pay careful attention to insure that short-term strategies contribute positively to our long-term trends.

In 1985, we were pleased with the gains made in sales, earnings, return on equity — and in the significant strengthening of our balance sheet through the combination of retained earnings and new equity.

But while these financial results were encouraging, we nevertheless believe our prime role in managing the assets of the enterprise is to look further ahead — toward the end of the decade and, indeed, the end of the millenium.

When we do that, a number of strategic considerations emerge from the welter of figures which are an essential — but sometimes difficult to understand — aspect of year-end reviews.

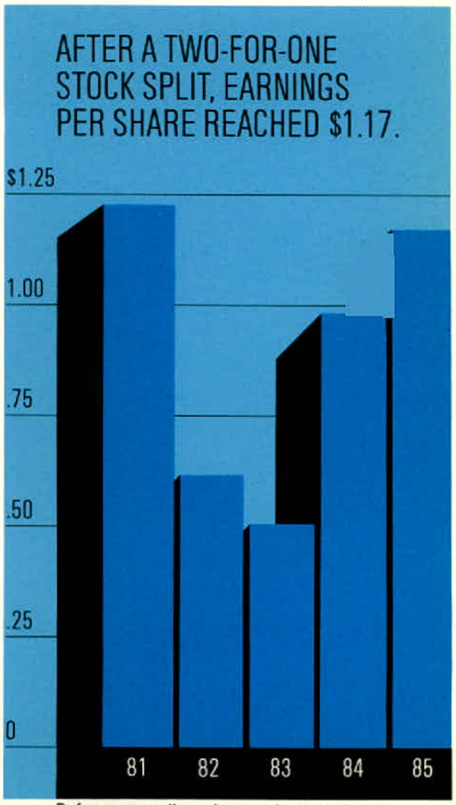
To begin with, in 1985, two major steps were made that should enable us to take advantage of the ongoing trend toward deregulation of industry in the years to come. In the United States, the formation of Standard Aero (Western) to serve a growing number of passenger and freight airlines (formed as a consequence of deregulation and often lacking in-house maintenance facilities) has proven to be a sound decision which is expected to pay dividends for years to come.

In Canada, the acquisition of Direct Transportation System Ltd. and its amalgamation with Canadian Motorways to form Motorways Direct will allow us to take advantage of anticipated steps to further reduce government involvement in Canadian transportation. Experience in both the U.S. and Australia shows that large, national, less-than-truckload carriers benefit most from deregulation. In Motorways Direct, we now have one of Canada's biggest and best equipped trucking companies serving LTL markets.

In the case of our strategy to reduce the cyclical volatility of your Company, our efforts were as intense, though less visible. We assessed several non-cyclical acquisition opportunities during the year and raised new equity to improve our cash position in anticipation of making such an acquisition. Simultaneously, we continued our investigations of the challenge of effectively managing business cyclicality and more fully developed and refined our strategies of planning, acquiring and managing for greater stability of earnings.

In 1986, we continue to pursue this important corporate strategy of structuring your company so that its earnings pattern over time can be consistently less volatile than that of similar industrial companies. In addition to our plan to acquire a relatively non-cyclical company as a nucleus for Federal's fourth group, all divisions within our three existing Groups are developing their own strategies for reducing their earnings volatility and its impact on our income statement.

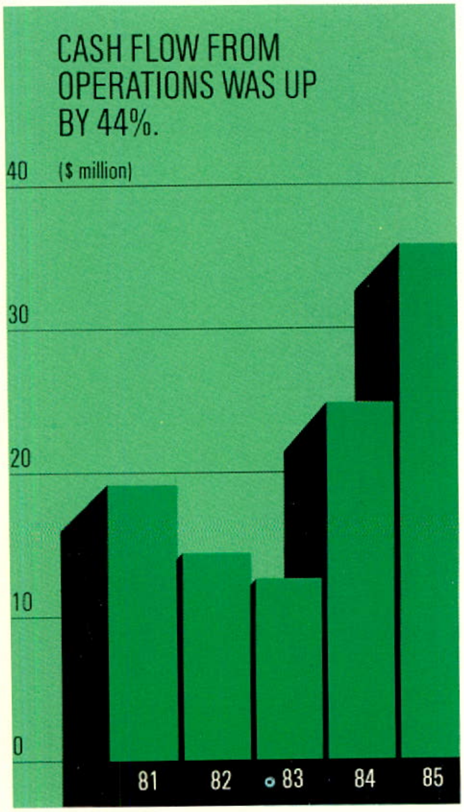
Another strategy that paid concrete rewards in 1985 was the restructuring and re-orientation of our Aerospace Group, begun a year



Before extraordinary items, where applicable, adjusted for two-for-one split.

earlier. As you will see on other pages in this Report, operating performance in all areas in which the Group is currently involved improved during 1985 and is well positioned in several growth markets for the future.

In 1981 The White Pass and Yukon Corporation launched a strategy aimed at insuring that your Company would not again be overly reliant on one sector, region or customer. That strategy proved to be vitally important when the Cyprus Anvil Mine closed in 1982. As a result, when new owners developed plans in 1985 to bring the mine back into production, we chose to pursue a very selective involvement using only existing resources — both assets and people — to enhance the profitability White Pass has recently achieved without inordinate risk. We believe the agreements we have made with Curragh Resources, the mine's operator, satisfy the strategic requirements of both parties, and we consider the goal set in 1981 to be achieved.



A common thread of all of the above strategies is that they involved a compromise between short and long term results, with a definite bias toward the longer term benefit to the Company.

Our strategies are developed and implemented by a team of highly skilled people. We take pride in the knowledgeable and dedicated individuals employed by the organization. In fact, the calibre of our people is the greatest single factor in our recent improvements in both revenues and earnings. Sustaining and enhancing the rate at which we develop the new managers necessary to maintain our momentum is both our greatest challenge and our highest priority.

Because of our plans for rapid growth, by necessity, many of the senior management people we require will come from outside the organization, through hiring and acquisitions. But it's gratifying and significant to see that managers are also being developed through internal sources. Within our corporate office two "graduates" of our Management Development Program have moved on to senior operating positions within the Groups. In addition, previous participants in our summer student program are now moving into responsible management positions, and new management training programs are being introduced throughout the Company.

It's our nature at Federal Industries to be enthusiastic, setting high standards in the pursuit of our challenging goals. Our fundamental measure of performance is return on equity and, while 1985's 16.2% was not as high as we feel is appropriate and attainable, it nevertheless reflects a positive trend — 1985 was the third year in a row that our ROE improved.

Looking forward to 1986, the continuing effect of our policy of fiscal prudence and a conservative long range approach to management, combined with a possible softening of the economy, may reduce the rate of earnings growth your Company achieved in 1984 and 1985. Should this happen, the effect would be short term. Our balance sheet is strong, sound strategies are in place, management is ready, the underlying trends are good, and we will be there when the *right* opportunities arise.

We can be that categorical in our assessment of Federal's future progress, primarily because of the depth of our planning process. Strategic planning is an ongoing exercise at both the Corporate and Group levels with a good interface between the Group's Chief Executive Officers and the Executive Committee at corporate office. In addition to the Corporate Long Range Plan, there are three well developed Group Long Range Plans which are coordinated to build an appropriate and significant contribution to Federal's future growth.

In the final analysis, the fundamental strengths of your Company can be summed up in four words: balance, growth, conservatism, and planning.

Using these terms, 1985 was the year in which our conservative approach and commitment to planning generated substantial growth and improved balance. While the weighting of the factors may change in coming years, we're convinced the overall result will be just as successful in the long term context.

THE FINANCIAL REPORT

JOHN S. PELTON
Vice-President, Finance

From a fiscal viewpoint, 1985 was a most successful year. Earnings, cash flow from operations, return on equity, liquidity and debt-to-equity ratio all improved. The cost of long-term debt capital was reduced and sensitivity to changes in interest rates was virtually eliminated. Common stock was split two-for-one, the dividend increased 20% and 2,300,000 new shares were issued at a new high price. Stock market values and volumes traded improved substantially, reflecting the recognition given by investors to the soundness of the Company's strategies.

CYCLES AND UNCERTAINTY

Acquisition opportunities, like all business activities, come in cycles. In 1985, we found a predominantly sellers' market, with most prospective acquisition targets selling for far more than any objective assessment of underlying value. Leveraged buy-outs in the United States rose to an all-time high of $144 billion, financed by a banking community seemingly prepared to provide unlimited funding. Auctions — as opposed to competitive bidding by qualified parties — have become the vogue, compressing time for analysis to an unreasonable degree.

These are games we won't play, and, as the previous "high" cycle in 1980-81 has shown, better values will arise for those who are patient, careful and choosy. The current economic recovery is over 40 months old, with experience teaching us that recession is more imminent than increasing growth. This, combined with structural changes such as U.S. legislation limiting tax deductions on goodwill and restricting the use of "junk bonds" on takeovers, should reduce prices substantially. It is worth noting that failed leveraged buy-outs from the previous cycle have been the predominant source of our recent acquisitions.

Uncertainty about the Canadian economy and, to a lesser degree, absence of prospective opportunities for expansion, have had a number of consequences that have affected our balance sheet and profit statements. The more cyclical components of our operations are preparing for demand fall-offs — reducing assets, tightening overheads, and thereby producing more cash flow than is required for reinvestment. Fixed assets declared redundant to the Company, are valued at estimated net realizable proceeds of almost $21 million. In addition, available cash and short term investments totalled over $50 million at December 31, principally from funds derived in equity issues and not yet redeployed.

The cumulative effect of this excess operational cash and substantial liquidity reserves is twofold: to strengthen the balance sheet; and, in the short run, to suppress earnings per share and return on equity. Investors should take comfort in the discipline underlying this situation, and, having regard for our track record of success in acquiring companies, should view the future optimistically.

It remains our policy at Federal Industries to raise equity before or at the same time as a major acquisition is made.

CAPITAL DEVELOPMENTS

1985 was a most active year with respect to the Company's capitalization. Negotiations with our principal bankers during the year resulted in centralizing credit responsibility at the Corporate office, and, more importantly, the release of security for all bank operating and term loans by March, 1986. This agreement increases control and flexibility in day-to-day funding, and the elimination of security opens up many new avenues of funding.

Base financing requirements for operations were insulated from interest rate fluctuations by the entering into of interest rate conversion agreements — commonly called swaps — effectively fixing the cost of funds for up to 10 years. Rates of interest on these Canadian dollar instruments were in the 11% area including costs, and swaps completed in early 1986 in U.S. dollars are even more favourably priced at just over 9%.

Further, investments in market-able, high quality floating rate preferred shares were made during the year, with the portfolio amounting to almost $38 million at December 31. Rates of return, after tax, are now running over 8%, with income gains from rising interest rates more than offsetting any increased costs on floating rate borrowings.

On October 10, 1985, the Company completed the issue of 2,300,000 common shares to a wide range of primarily retail investors, for net proceeds of approximately $25 million. The purpose of this offering was several fold:

1) to provide an equity base for the over $100 million in assets acquired since the last issue;
2) to prepare the market for the acquisition of a future "fourth leg";
3) to broaden the distribution of stock with emphasis on the smaller shareholder;
4) to increase the trading "float" of shares.

All the foregoing objectives were met, with the added bonus of a substantial improvement in market price from issue at $11.25 to early March 1986 value of $15.50.

Federal Industries expects to come to the market frequently as it continues its growth trend, and our attention to shareholders' interests is a key and ongoing strategy.

ACQUISITIONS

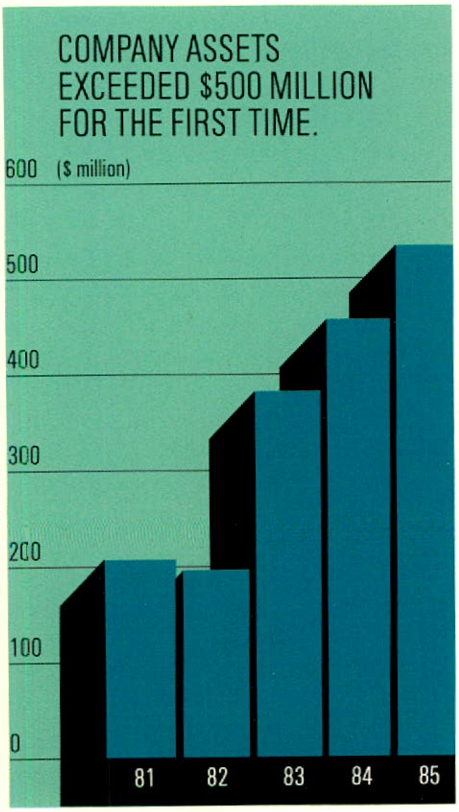
Two significant acquisitions were negotiated during 1985 — Direct Transportation System, completed September 27, 1985 and I. Bahcall Steel & Pipe, which closed on January 16, 1986.

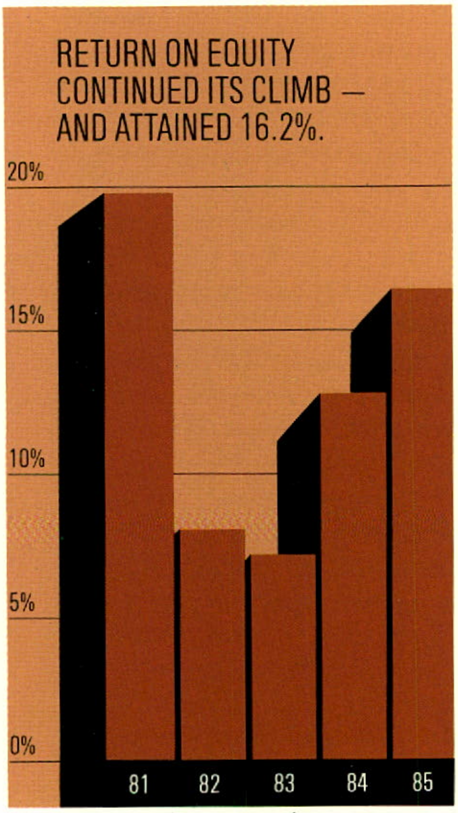
Direct was acquired essentially for assumption of liabilities, with a total asset value just under $49 million. Third party debt of approximately $21 million was paid out on closing, financed in part through the October common stock issue. Redundant assets of over $10 million were created through the operational merger of Direct and Canadian Motorways, of which $4.4 million has been realized to date. The merger also provided an opportunity to rationalize terminal locations, and to substantially reduce the attendant fixed costs. Adequate reserves for transaction and transition expenses have been provided.

Bahcall, a Wisconsin-based distributor of general-line steel products, was acquired for approximately $5 million U.S., payable partly by note and partly by cash.

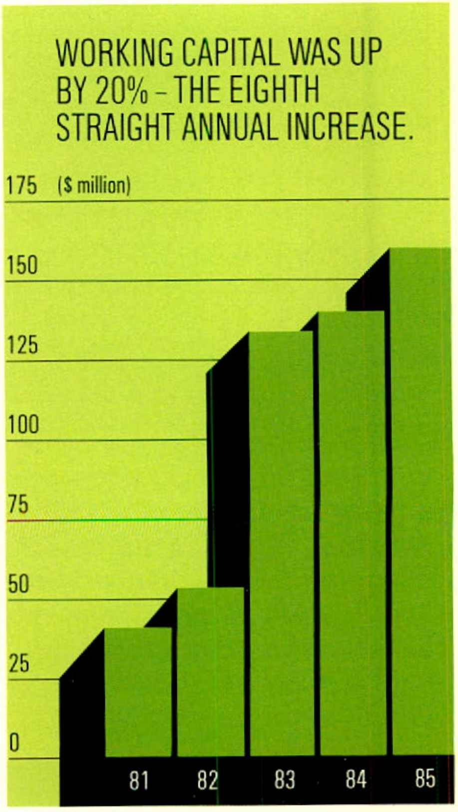
Both Direct, in combination with Canadian Motorways, and Bahcall are strategic initiatives of the Transport and Industrial Distribution Groups respectively, and are referred to as "tuckunders". Managed by seasoned industry executives, both are relatively low risk paths to expansion, and are expected to return better than the current target of 25% on net assets. This goal is the measure of earnings before interest and taxes as a percent of operating assets less non-interest bearing liabilities.

As mentioned earlier, the current sellers' market for acquisition oppor-





Based on opening common equity.



tunities has been responsible largely for the Company not purchasing a substantial fourth industry operation. In the 1984 Report to Shareholders, management referred to a new strategy designed to mitigate cyclical volatility in earnings. One aspect of this strategy envisions the fourth "leg" as having more stable profit characteristics through the business cycle. We remain committed to this goal, and are actively pursuing every avenue to implement the plan.

INCOME TAXES

The average effective tax rate for 1985 was virtually unchanged from 1984 at 39.5%, and over 70% of the total tax liability of $12.2 million was deferred, compared to 88% last year.

However, for the 1985 year, accounting for investment tax credits changed. In prior years, these credits were applied to reduce current taxes payable, while in the current year, the Canadian Institute of Chartered Accountants has required that fixed assets be reduced by the credit instead. The effect of this was to reduce net earnings by over $1 million in 1985 compared to 1984 treatment. However, reduced depreciation will result in 1986 and later — benefiting future profitability.

In the latest Federal Government budget, inventory tax allowances were eliminated, resulting in a reduction of 1986 earnings of approximately $1.3 million. Lowering of corporate tax rates for 1987 onwards will help to counterbalance this measure.

ASSET MANAGEMENT

In assessing operating performance, we have chosen return on net assets because, in Federal's structure, Corporate office largely determines what capital and assets each subsidiary controls, and because comparing our performance against other industry participants by this kind of measure eliminates the effect of varying leverage strategies. The intent of this strategy is to encourage each subsidiary to be structured competitively for its industry while at the same time keeping our fiscal prudence objectives intact.

In our investigations of many potential acquisitions and in studying the fundamentals of our subsidiaries, we have found that the asset mix controlled by an operating company is often inappropriate to the fundamental thrust of the business. In many cases, property is owned when leasing makes more sense, or assets owned are in excess of those required by the business. Management may have acquired such assets as a result of corporate reorganizations, through diversification or growth strategies that did not succeed, or through a mistaken notion of business objectives, or for a wide variety of other reasons. They hang onto them in many cases because they are unable to divest successfully, or because doing so would require diversion of management attention from making money at the business it knows best. These assets ultimately have the effect of "dragging down" subsidiary and Federal's rates of return, since capital continues to be tied up in their ownership.

Our objective here is to identify the optimum asset structure for each operating subsidiary in accordance with fiscal prudence, and work with them to optimize profit performance. To do this, we devised what we sometimes call the "Redundco" strategy, wherein each company establishes a separately accountable business unit containing "redundant" assets. Each Group is charged to identify assets that are either underperforming relative to minimum criteria or redundant to operations, and provide plans for converting these Redundco assets into cash. Progress on implementation of these plans is monitored on a quarterly basis.

In recent years, our strategy has been to shift the structure of the Company toward operations that are less capital intensive, and that strategy has worked well. We will have achieved what we consider to be about the right balance as soon as the identified remaining redundant assets have been disposed of.

We now face a new and significant challenge — to improve significantly the management of *current* assets. This is an area where operating effectiveness can make an enormous difference to profitability. The magnitude of this opportunity has been clear for several years, and the operating companies have made progress toward improved current asset control.

The proficient management of current assets is at the heart of fiscal prudence, and is vital to the minimizing of Federal's cyclical volatility. The world of business is full of examples of companies whose *current* assets rise when the economy softens — indeed, a degree of such rise is almost inevitable because of the lag between orders and deliveries of materials, etc. — a factor that is highly variable between industries. The challenge to management is to understand the fundamentals of their industry, anticipate the direction of the economy as well as possible, minimize forward commitments, and react quickly to news of a softening of business.

CONCLUSION

Federal Industries has continued on its expansion path, and at the same time has improved its financial strength and enhanced total shareholders' returns. We are prepared for the fiscal requirements of growth in the future, and have retained the discipline to act only where opportunities improve the Company's underlying value.

THE PLANNING REPORT

R. J. VAHSHOLTZ
Vice-President, Planning

During 1985, a major part of our planning activities centered upon our next "standalone" acquisition. A standalone is an acquisition that will report directly to Federal's Corporate Office and will form the basis of a fourth Group — and it is targeted to be acquired sometime in 1986 or 1987, assuming a suitable acquisition candidate be found.

The search for this standalone actually began late in 1984 and by year end 1985, it was in full swing with a dozen or more acquisition targets being evaluated — new ones being added every few weeks and rejected candidates being set aside. While this search process was coming up to speed, we also did a lot of work on the criteria that guide our search.

The reason we're looking for another standalone is two-fold.

First, we need at least one more operating group to meet our growth objectives. We have determined that our existing Groups have plenty of opportunities for both internal growth and by "tuckunder" acquisitions, but they, like most businesses, are limited by the rate at which they can develop management. One way we at Corporate Office can and do develop operating management is through the acquisition of well managed companies.

Second, we have set an objective to continue to maintain better than average stability of earnings through the upcoming business cycles. Studies made during 1984 showed us that there are many industries meeting our general acquisition criteria that have inherently low earnings volatility. In 1985 we dug into the reasons why the patterns of industry stability are so hard to detect, and we became convinced it's because *management skill and commitment is a bigger factor than industry orientation.* This was confirmed by our experience. Consequently, we have directed our search for a standalone toward stable industries, but have also launched a series of strategies to further reduce the earnings volatility of our existing three groups of companies.

The Corporate Long Range Plan sets out ambitious goals — to become a Great Canadian Company having consistently above average earnings, below average earnings volatility, and growth to more than $3 billion sales by 1995. And we are committed to attain those goals.

We believe we can do so because we have the foundation, the momentum, and the plan. Our plan recognizes the difficulties of making projections in turbulent times, and it has all kinds of cushions to protect us against events no one can anticipate. For example:

Our Standard of Measure: We do not have rigid fixed objectives. We simply say we'll become a Great Canadian Company and perform better than the average of similar Canadian companies, and we've developed objective ways to measure our progress.

Our Growth Cushion: Our current estimate is that we require a 17% rate of growth to 1995. Our plan shows more than 20% growth, and requires us to do nothing we have not already done successfully.

Our Management: We spent several years developing the systems and procedures to make this kind of plan work. They're not perfect, but they are proven workable. Federal's corporate management team and our operational management teams are better than average, improving, and performing in accordance with the plan. Our management strength is in the area of business strategy, and we believe that to be the vital strength for managing in turbulent times.

Fiscal Prudence: Finally and of greatest importance, we recognize that this plan might fail, and we are committed to strategies that never bet the company on our assumptions proving right.

The Operations Report

WILLIAM E. WATCHORN
Vice-President

The impact of corporate restructuring can be difficult to isolate and quantify, particularly in the short term.

But in the case of the Group reorganization carried out in 1984, and described in last year's annual report, that's not the case.

Our decision to establish Groups based on industries — each led by an experienced Chief Executive Officer — has proven itself effective from the start.

The results have been a more effective liaison between Corporate Office and the field... significant improvements in strategic planning at the operational level... and, we believe, capitalization on opportunities which have been translated into higher sales and profitability.

In addition, it's the conviction of Federal's Executive Committee (which now includes the Group CEOs as *ex officio* members), that the greater control and responsiveness inherent in the new management structure, helps to insulate Federal more effectively against the ups and downs of our various marketplaces and of the economy.

One of the most important requirements for the continuing growth and success of Federal will be the development of excellent managers primarily by and within the operating Groups. During 1986, the many existing programs will be enhanced and new initiatives undertaken to identify and develop competent managers.

1985 was a year of major change and growth for the Federal Industries Aerospace Group. Sales increased by 34% to $140 million. Further improvements are expected in 1986.

During the year, banking and cash management for the Groups was brought together at Corporate Office under Mr. J. Douglas Sherwood, who was hired in 1985, as Vice-President and Treasurer. This restructuring has improved the co-ordination efficiency of our operations in this area and lowered the cost of capital to the Company.

AEROSPACE

For the Aerospace Group, 1985 was a year of major change and rapid growth. Serving five distinct aviation markets (business, commuter, helicopter, air transport and military), the Federal Industries Aerospace Group now has stronger management, broader marketing programs, and improved facilities.

Over the year, Group sales increased by 34% to $140 million — generating an operating profit of $7.3 million, up 47% over the previous year. Further improvements are expected in 1986.

Major goals for the Aerospace Group were accomplished, including, opening of a 285,000-square-foot airframe maintenance facility in Phoenix, Arizona, increased penetration of the U.S. engine repair and overhaul markets, achievement of increased aircraft parts sales and addition of engine overhaul services for the popular Pratt & Whitney PT-6 turbo prop engine.

During the year, the aircraft parts distribution and repair and overhaul businesses were integrated into one Small Engine Division. The soundness of this strategy — which allows marketing of aircraft parts and overhaul services through one field force — was confirmed by growth in sales of 25% for the Division. Making the major contribution toward this effort was the aircraft parts and accessories segment, which registered a 29% increase in sales. Engine repair and overhauls accounted for a substantial 21% rise in sales, even though the new PT-6

AEROSPACE GROUP

EDWARD G. KELLEY
President and Chief Executive Officer
Aerospace Group

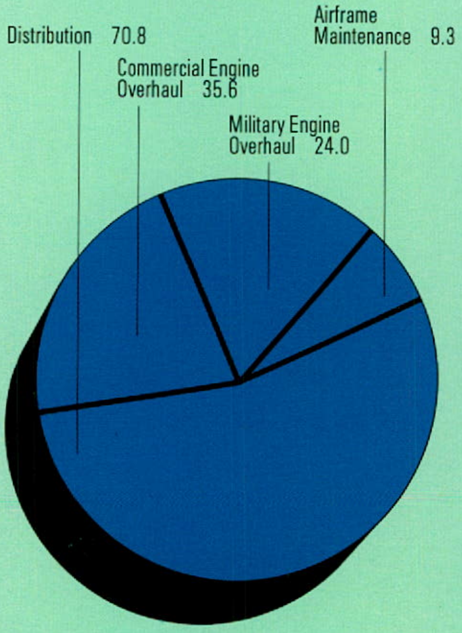
"The aviation industry is undergoing a paradoxical change throughout the markets we serve. Even though operating costs have stabilized and fuel prices are lower, competition is tougher than ever. That paradox holds true for airline customers who need airframe overhauls — and for business aircraft operators who buy our parts and engine overhaul services.

For the air carriers, expanding routes and reduced fares are stretching fleets across the country and creating a huge demand for maintenance services and modifications.

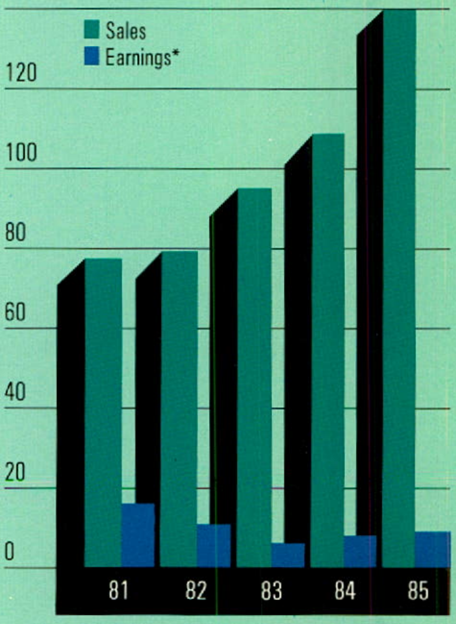
Our customers, particularly in the airline market, are looking for every possible savings to turn an operating profit. Standard Aero Western...and eventually a sister operation in the East...will make it possible for airlines to get top notch, economical maintenance services — without the high overhead and historical labour problems the industry has faced.

In business aviation, where our Small Engine Division provides parts and engine repair and overhaul services for executive turboprops, utility helicopters and commuter airlines, operators are trying to get maximum usage from their fleets. They usually don't have the ability to use alternative aircraft when maintenance needs come up — so we're attacking this market with expanded field service, more service centres and faster delivery of parts and overhaul services."

SALES DISTRIBUTION
(for the year ended Dec. 31, 1985, $ million)



FIVE YEAR REVIEW
($ million, before taxes, extraordinary items and interest.)*



The Federal Industries Aerospace Group repairs and overhauls aviation and industrial engines and accessories, provides commercial airframe maintenance and distributes aviation parts and accessories in Canada, the United States, western Europe and the Far East.

engine line did not become operational until the year-end. Of this total, approximately 70% of sales were Canadian, with the balance from foreign customers. Canadian sales breakdown between military and commercial customers was 59:41%.

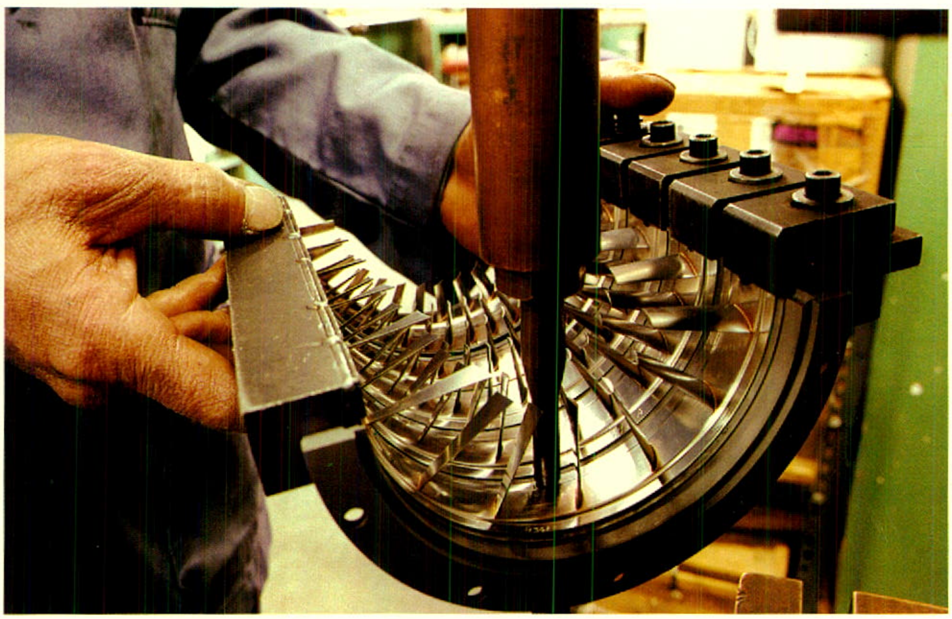
The Small Engine Division's Winnipeg complex was expanded by 70,000 square feet to a full 270,000 square feet. The expansion will improve the flow of product through the plant for the existing engine lines and the new Pratt & Whitney PT-6A line. Both the existing Allison 250 and 501 engines plus the new P&W PT-6 engine lines have enjoyed good penetration in the U.S. and Canada, following the strategy to add more civilian markets, while maintaining its pre-eminent turbine engine overhaul business with the Canadian military.

During the year, Standard Aero developed a low-cost modification process to increase horsepower, reduce fuel consumption and lower operating temperatures for several Allison turbine engines. This "Magnum 250" process is adaptable to other makes of aircraft engines and is expected to generate additional demands for Standard Aero's overhaul and repair services.

In hand with its organization of aviation parts distribution on a regional basis, Standard Aero is developing a network of strategically located service centres in both the U.S. and Canada to provide engine servicing and field repairs between overhauls. Regional service centres are already in operation in Vancouver, British Columbia; Dallas, Texas; Van Nuys, California and Charlotte, North Carolina. Similar facilities will be established at other key centres in the U.S. and Canada during 1986.

The Group's most visible change for 1985 was the inauguration of Standard Aero Western Division which is providing a wide range of maintenance services to the U.S. commercial aviation industry from

Standard Aero Western, inaugurated in 1985, provides a wide range of maintenance services to the U.S. commercial aviation industry. Standard Aero, based on SAW's success, is actively pursuing an eastern U.S. maintenance facility.



The effect of consolidation of aircraft parts distribution, repair and overhaul into the Small Engine Division at Standard Aero helped build sales by 25% over the year.

Engine repair and overhauls accounted for a substantial 21% increase in sales for Standard Aero in 1985, even though the new PT-6 engine line did not become operational at the Winnipeg plant until the year-end.

its base in Phoenix, Arizona. SAW represents the Group's first initiative in capitalizing on the many opportunities resulting from deregulation of the airline business in the United States. Standard Aero Western, which achieved the fastest full FAA certification on record (allowing it to perform regulated maintenance and modifications on all types of aircraft), has enjoyed significant initial volumes.

By offering passenger and freight airline quality services at a lower cost, Standard Aero Western is well positioned to serve airlines that can't justify their own maintenance facilities for major airframe overhauls and structural modifications. From a start-up in March, the Division grew from four employees to nearly 350 and served a variety of major customers including CP Air, Pacific Southwest Airlines, Southwest Airlines, and Alaska Airlines and sub-contract work for McDonnell Douglas involving major modifications on aircraft.

In January, Standard Aero Western signed a two year maintenance

The Small Engine Division of the Aerospace Group expanded its Winnipeg complex to a full 270,000 square feet to accommodate growth — and to improve plant efficiency.

contract with Federal Express Corporation for scheduled block "C" checks, and for repainting and modifications for 11 DC-10 aircraft.

Joint marketing of services to Standard Aero Western's air transport customers also generated dramatic growth for PF Industries, the Group's Seattle-based airline ground support equipment manufacturing arm. Production capabilities and product lines at PF Industries are being expanded to handle additional customer demand.

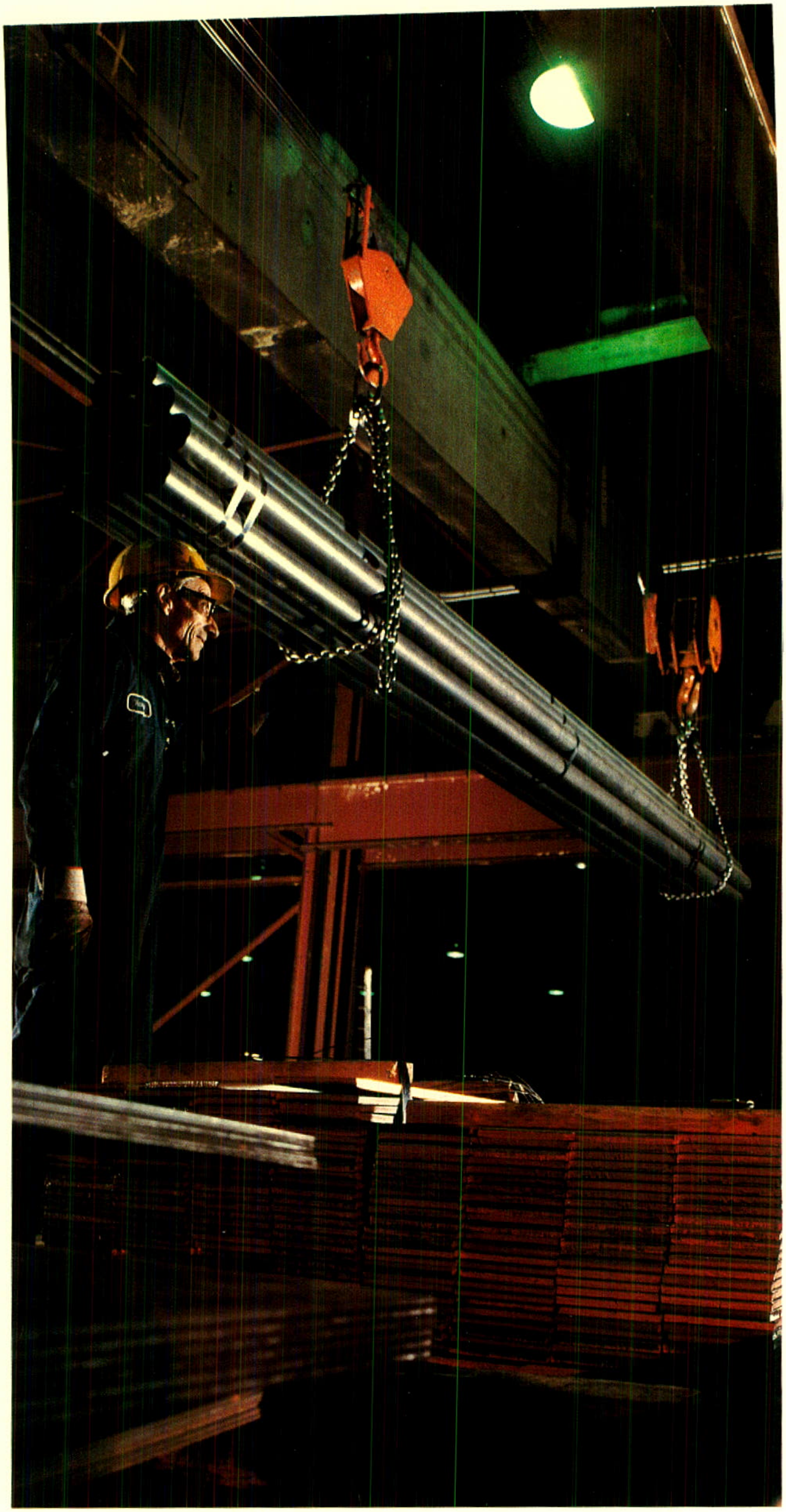
Further expansion is planned for the Aerospace Group in 1986. A large percentage of this growth will come as investments made and programs implemented over the past two years in the existing divisions come to greater fruition. In addition, Standard Aero is pursuing engine assembly contracts, actively investigating the establishment of an eastern U.S. transport maintenance facility to parallel Phoenix, and considering the development of a large jet engine overhaul division.

INDUSTRIAL DISTRIBUTION

In its second year as part of Federal Industries, the Industrial Distribution Group generated revenues of $385 million — up more than 25% from 1984. Earnings from operations were $21.4 million — an increase of $3.3 million or 18%.

The largest single factor shaping results for the year was an increased demand for steel, in general, and inclusion of a full year's results from the Wirth companies, Chatham Steel and Can Copco. Each of these operations, acquired during 1984, were profitable in 1985.

The year saw the continuation of the business recovery which began in 1983. Consumer spending on automobiles, appliances and other durables continued to increase, fuelling demand for flat-rolled steel products in sheet and coil form. The primary market for these products is in Ontario where all the Group's units turned in solid performances.



Sales for the Industrial Distribution Group increased by more than 25% to $385 million in 1985 on the strength of higher demand for steel and the contribution from Wirth, Chatham Steel and Can Copco.

Residential construction turned up sharply in 1985 and the long awaited recovery in business outlays on plant and equipment appears to be underway. These increases in capital spending had a generally helpful effect on operations across the country although not all areas shared equally. British Columbia benefitted from the construction requirements for Expo '86 but the lumber industry remains in the doldrums in that province and activity in the ship building industry has slumped badly.

Across the country, markets for agricultural machinery weakened further in 1985 and the consumption of steel by major manufacturers was at very low levels. The demand for road transportation equipment, however, continued to be brisk.

The recovery of the oil and gas industry in 1985 resulted in significantly improved operating earnings for the Group's Alberta branches. More recently, however, this recovery has been threatened by the sharp fall in energy prices.

Operationally, the emphasis in 1985 was to increase the efficiency of asset utilization, and in building productivity. Significant progress was made — particularly in the management of inventory — which forms a large portion of the Group's assets. Experiments with inventory management strategies, based on "just in time" techniques developed by the steel mills to service the automotive industry, led to an improvement in inventory turns in the Canadian Steel Service Centre Division.

In the Specialty Distribution Division, performance improved steadily throughout the year, assisted by modest improvement in market conditions. International trading provided both valuable insight into world steel markets, as the Group's "window on the world", and profitability beyond budgeted expectations.

Industrial Distribution Group

WAYNE P. E. MANG
President and Chief Executive Officer
Industrial Distribution Group

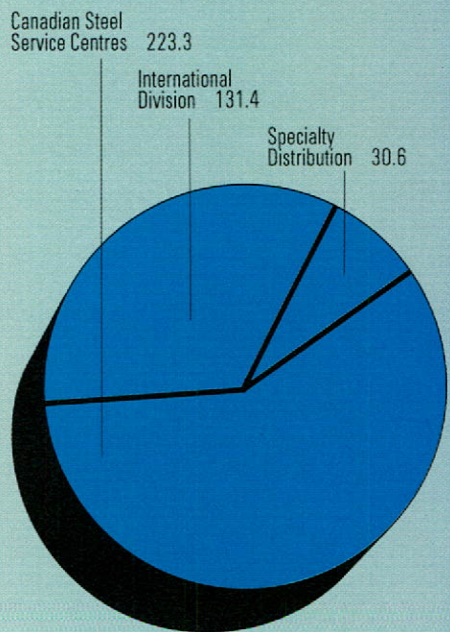
"Despite the fact that we rely extensively on computers to help us manage a variety of assets that are "fixed" in more than name only, *people* are the key factor in the Industrial Distribution Group's ability to run existing businesses ...and to create new ones.

So, historically, we've invested a significant amount of time in developing strategies to hire, train, compensate, retain, develop — and recognize — our people.

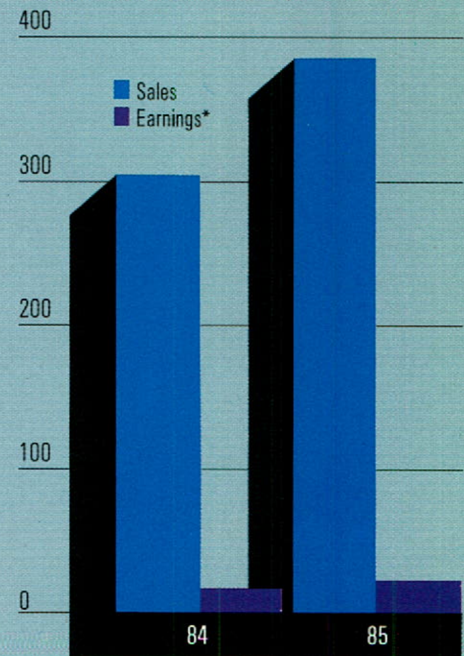
We believe our operations have always been efficiently run. At the same time, we're convinced that truly superior performance is a product of each individual directly sharing the goals, the rewards — and to some extent the risks — of the business.

Our new plans provide this impetus and should make a significant contribution to the molding of our future."

SALES DISTRIBUTION
(for the year ended Dec. 31, 1985, $ million)



TWO YEAR REVIEW*
($ million, before taxes, extraordinary items and interest.)*



**The Group was acquired December 31, 1983.*

The Federal Industries Industrial Distribution Group distributes general line, flat-rolled and specialty steel products in Canada and the United States; markets industrial valves, piping components and related products; and imports carbon steel, aluminium, rails, wire and pipe products.

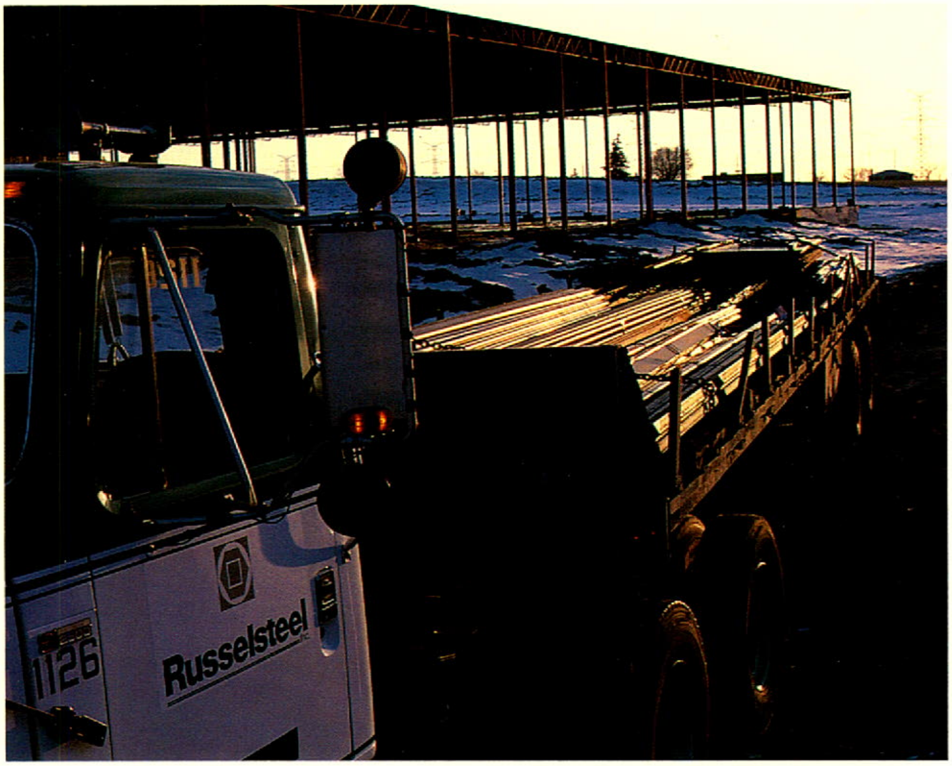
The new U.S. Steel Service Centre Division acquired its first operating company early in 1986. I. Bahcall Steel & Pipe is the predominant steel service centre operator in its market area. The Company was acquired on good terms and should contribute profits beginning in 1986. I. Bahcall employs 115 people and distributes steel from four outlets located in the states of Wisconsin and Minnesota. Experience with this initial acquisition will help shape the Industrial Distribution Group's approach to further involvement in the U.S. steel service centre industry.

Looking to 1986, results will be largely dependent upon general economic conditions in Canada. The 1986 business plan assumes that a downturn in demand will occur during the last half of the year; however, actual results for the first two months reflect a continuation of the sales growth experienced in 1985.

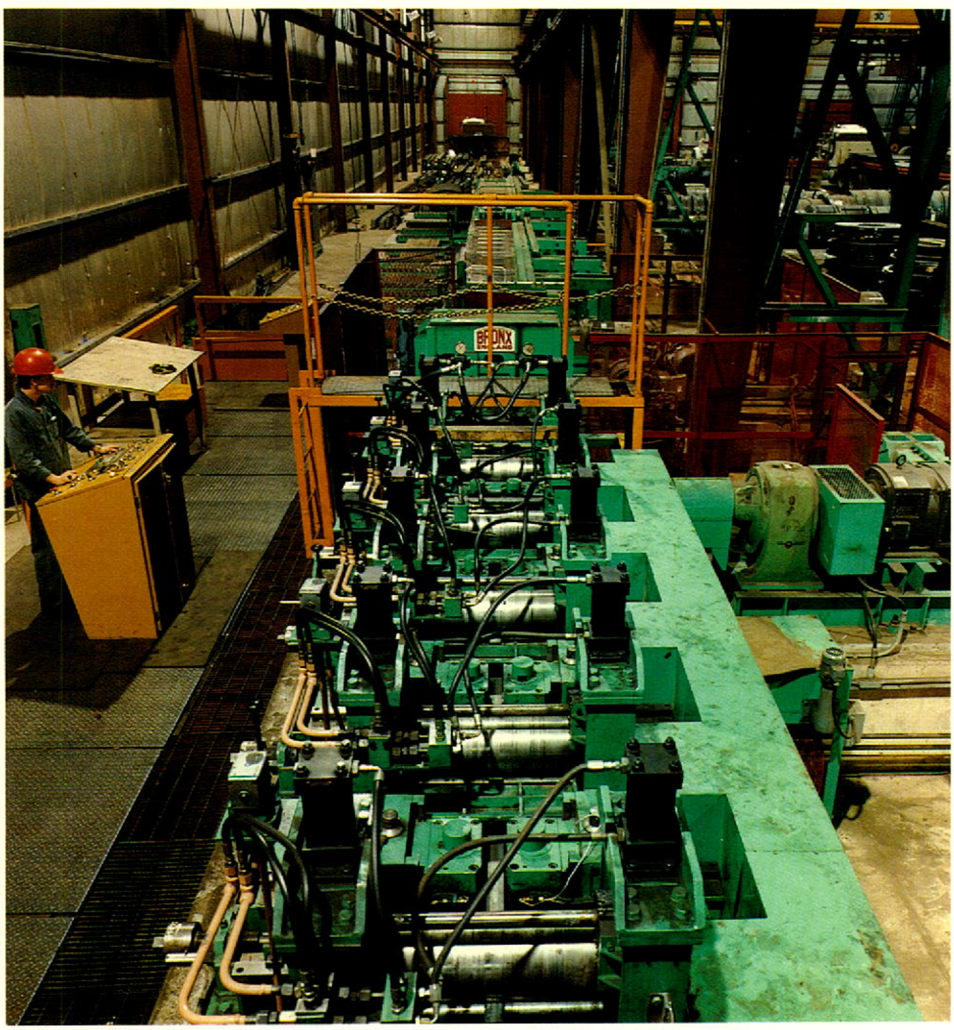
Demand for automobiles and consumer durables — significant factors in the demand for flat-rolled products — is typically cyclical. Lower oil prices, while beneficial in the long run, may cause some short-term disruption in the capital expenditure plans of industries served by the Group's steel service centres located in the oil-producing regions of Canada.

A major future objective of the Industrial Distribution Group is to reduce earnings fluctuations throughout the business cycle. Over the next few years, it's expected that rationalization of product lines by Canadian steel mills, together with increased service requirements (including "just in time" delivery) from customers, will mean a larger market share for steel service centres in both Canada and the U.S. A number of strategies are being assessed that will help the Group take greater advantage of these market opportunities as part of an industry in transition from high and more volatile growth in the 1970s to

The new U.S. Steel Service Centre Division made its first acquisition in early 1986. Experience with I. Bahcall Steel & Pipe in Wisconsin and Minnesota will help shape the Group's approach to further acquisitions in the United States.



A recovery in plant and equipment spending by industry had a positive effect on steel sales in most areas of Canada.


Consumer spending on automobiles, appliances and consumer durables fueled greater demand for flat-rolled steel.

the more mature market expansion of the 1980s.

TRANSPORT GROUP

As planned, Federal Industries' Transport Group made a substantial contribution to the Company's performance in 1985, by providing more than 40% of overall net income while continuing to expand its scope of operations and building market share.

Revenues reached $194.1 million for the year (up 21%). At the same time, operating income grew by 5% over 1984 to $24.2 million.

By far the most important development during the year was the acquisition of Direct Transportation System Limited, one of Canada's largest general freight trucking carriers, under an agreement signed July 3 and concluded with the completion of regulatory approvals on September 27, 1985.

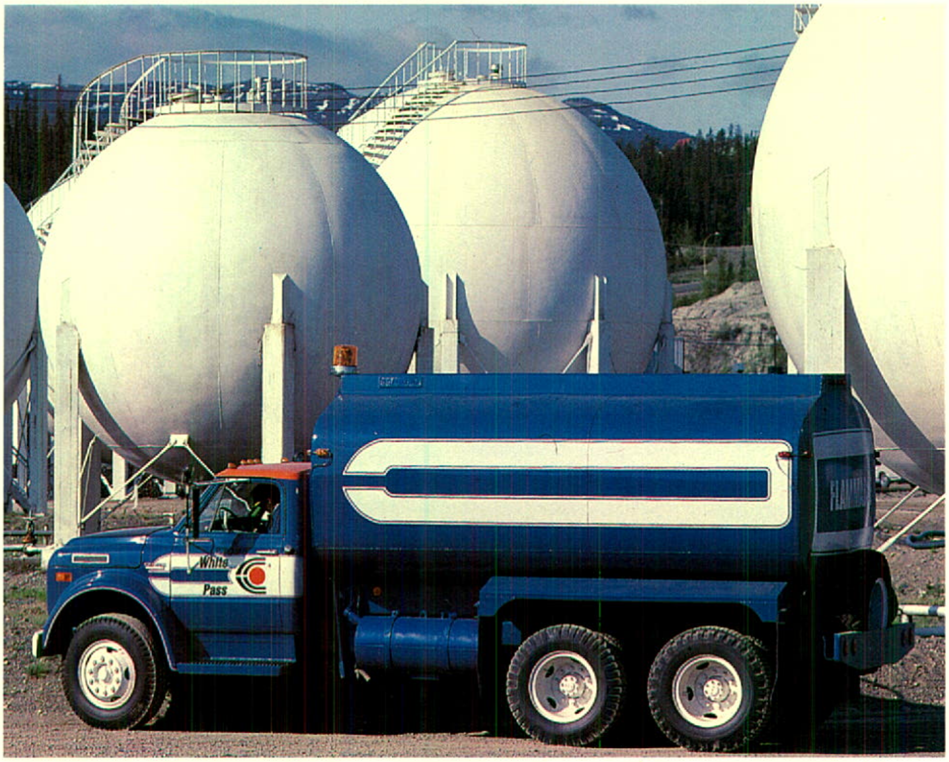
After a search of nearly 18 months, Direct was identified — because of its strong eastern Canadian presence — as an ideal acquisition to counterbalance Motorways' dominant position in western Canada. In the short term, the consolidation of the two companies will produce a significant reduction in staff and fixed assets, without any significant loss of sales volume.

Over the longer term, the major opportunity is in aggressively marketing the Company's strengths in the Canadian markets that are expected to be subjected to a considerably lower level of day-to-day government regulation.

In a deregulated environment, international experience shows that the larger, national LTL carriers enjoy the greatest success. Motorways Direct has one of Canada's broadest networks of LTL terminals — and is currently updating its fleet to provide larger numbers of new "doubles" trailers which will increase operational flexibility, efficiency and revenue per mile.

In the year to come, management at Canadian Motorways plans to complete the integration of Direct into the Motorways family, improve customer service and operating efficiency, profitably expand the special commodities division and improve cost control through new operating techniques and improved computerized information systems. All of these steps are expected to yield improved profits in 1986 as Motorways Direct builds momentum.

At The White Pass and Yukon Corporation Limited, 1985 was a pivotal year. The company was able to capitalize on its unique strengths in petroleum distribution, oil rig moving and docking activities — resulting in an increase in revenue of 33%, and a corresponding improvement in operating income.



The White Pass and Yukon Corporation made gains in both market share and volume of petroleum products sold.

Motorways Direct is now one of Canada's largest less-than-truckload carriers. The Company is expanding its fleet of "doubles" trailers to increase operating flexibility and efficiency.

In the north, the general economic situation in both Alaska and Yukon remains soft. Nevertheless, White Pass made gains in both volume of petroleum products sold and market share as a result of an integrated marketing strategy implemented during the year.

Shipping and railway operations in the north remain suspended. However, negotiations continue on all fronts to resolve the status of these Divisions.

In mid-1985, Curragh Resources Corporation announced that it had completed an agreement for the purchase of the Cyprus Anvil Mine in Yukon. White Pass subsequently entered into an agreement with Curragh to provide access to the company's ore terminal in Skagway, Alaska. The mine is expected to re-open in 1986; however, timing is dependent upon a number of factors.

White Pass Systems Ltd., which specializes in the movement of oil drilling rigs and camps, completed its first full year of operations in 1985, with sales exceeding targets by nearly 25%. Given the downturn in the world price for oil, and expected cutbacks in exploratory activity, 1986 will be a challenging year for White Pass Systems. White Pass Systems will also seek to expand its bulk hauling business as a balance to its oil service activities. For the longer term, the Division is building a strong position as the industry's best equipped and best managed rig moving company.

At Thunder Bay Terminals Ltd., sales of $21.6 million were off six percent from the record levels established in 1984. This was a direct result of slightly lower coal and potash volumes at the Terminal.

Shipments of Ontario Hydro coal continue to reflect negotiated decreases in tonnage from one major supplier. On the year, this amounted to 264,200 tonnes of lost throughput.

TRANSPORT GROUP

THOMAS H. KING
President and Chief Executive Officer
Transport Group

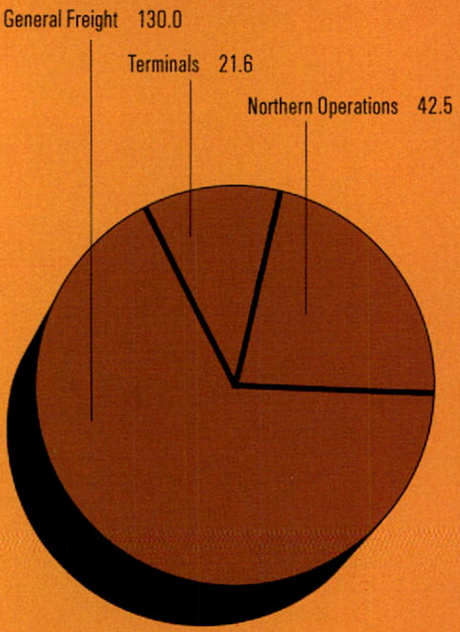
"The year past meant significant change for all business units in the Transport Group. Senior management has been strengthened at Canadian Motorways Ltd., White Pass North, and Thunder Bay Terminals as we work to develop the management, staff and systems within each organization to generate the optimum performance and to provide the service our customers demand.

All operations have also expended considerable energy in the area of cost control. We intend to further improve the level of profitability within each Division with a focus on management development, improved management information, financial systems, and using the leverage of our much expanded operations in purchase decisions.

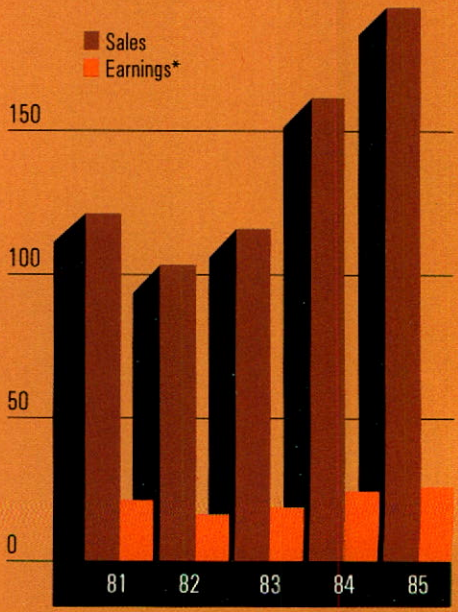
Looking outside, business development remained a high priority for the Transport Group during 1985 and saw the conclusion of the Direct System acquisition and a long-term agreement to provide services to Curragh Resources, new owner of the Anvil Mine in Yukon.

Our efforts in this area will intensify as we move forward to complete projects for the northern operations; strive to solidify our market share at Canadian Motorways Ltd. and White Pass Systems; and attempt to enhance long-term potential at Thunder Bay Terminals Ltd."

SALES DISTRIBUTION
(for the year ended Dec. 31, 1985, $ million)



FIVE YEAR REVIEW
($ million, before taxes, extraordinary items and interest.)*



The Federal Industries Transport Group provides a variety of freight transportation services in Canada and the northern United States, operates bulk product transshipment facilities, transports drilling rigs and related equipment in western Canada and distributes petroleum products in Alaska and Yukon.

Sales at Thunder Bay Terminals, which were down by 6%, reflected lower throughput of coal and potash during the year.

Counterbalancing this were new movements of metallurgical coal totalling nearly 125,000 tonnes. TBTL management is hopeful that further volumes of this commodity will result given the apparent success of initial shipments.

Compared with records set in 1984, potash volumes were off nearly 19% due to shifts in the marketplace and generally lower levels through the Port of Thunder Bay. In the face of depressed agricultural markets, movements of agricultural products dwindled, with only 7,800 tonnes handled at the Terminal. The year to come should be one of stabilization at the Terminal, with results largely unchanged from 1985.

In 1986, Motorways Direct plans to build profits through improved customer service, operating efficiency, an expanded Special Commodities Division and better cost control.

Financial Information

CONSOLIDATED BALANCE SHEET

ASSETS

At December 31, 1985		$000	
	1985	1984	1983
Current			
Cash and short term deposits	$ 12,449	$ 11,728	$ 18,551
Short term investments	37,917	23,470	—
Accounts receivable	132,841	110,503	74,370
Income taxes recoverable	2,109	3,010	2,770
Inventories (Note 3)	142,687	135,806	105,259
Prepaid expenses	3,023	2,308	2,052
Current portion of long term receivable (Note 4)	3,850	3,850	3,850
Total current assets	334,876	290,675	206,852
Fixed (Note 5)			
Property, plant and equipment	261,105	224,421	254,547
Accumulated depreciation	91,074	83,468	100,277
	170,031	140,953	154,270
Other			
Long term receivable (Note 4)	3,492	3,408	2,702
Other investments, at cost	4,745	4,346	3,027
Deferred charges	7,701	5,328	5,162
Goodwill	2,333	2,113	2,043
Other intangible assets	5,699	2,909	2,913
	23,970	18,104	15,847
	$528,877	$449,732	$376,969

LIABILITIES

At December 31, 1985		$000	
	1985	1984	1983
Current			
Bank indebtedness (Note 7)	$ 49,750	$ 53,246	$ 10,344
Accounts payable and accrued liabilities	112,297	92,154	62,372
Dividends payable	1,945	1,629	801
Current portion of long term debt	6,438	6,271	6,861
Total current liabilities	170,430	153,300	80,378
Long term debt (Note 6)	167,530	146,492	146,311
Deferred income taxes	13,029	11,215	7,567
Minority interest (Note 8)	6,774	6,496	5,500
Total liabilities	357,763	317,503	239,756
Contingencies and commitments (Note 14)			
Shareholders' Equity			
Share capital (Note 9)	114,717	88,166	87,662
Retained earnings	53,918	42,888	49,551
Cumulative translation gain (Note 1b)	2,479	1,175	–
	171,114	132,229	137,213
	$528,877	$449,732	$376,969

On behalf of the Board

Director

Stewart A Searle

Director

See accompanying notes to financial statements.

CONSOLIDATED STATEMENT OF EARNINGS

For the year ended December 31, 1985		$000	
	1985	1984	1983
Sales and services (Note 12)	$719,038	$572,591	$203,798
Cost of sales and operating expenses	659,879	521,874	177,824
Depreciation	10,642	9,584	7,092
Amortization	710	614	155
Interest on long term debt	17,168	17,077	8,427
Other interest expense	4,062	2,957	1,317
Investment income	(2,607)	(2,503)	(984)
Gain on sale of fixed assets	(1,670)	(2,907)	(1,504)
	688,184	546,696	192,327
Earnings before income taxes and extraordinary item	30,854	25,895	11,471
Provision for income taxes (Note 11)			
Current	3,616	1,177	2,335
Deferred	8,576	9,014	2,841
	12,192	10,191	5,176
Earnings before extraordinary item	18,662	15,704	6,295
Extraordinary item (Note 13)	–	15,219	–
Net earnings	18,662	485	6,295
Earnings allocated to minority shareholders	654	491	371
Net earnings (loss) for the year	$ 18,008	$ (6)	$ 5,924
Earnings (loss) per common share (Note 10)			
Before extraordinary item	$1.17	$ .99	$ .51
Extraordinary item	–	(1.29)	–
Including extraordinary item	$1.17	$(.30)	$ .51

See accompanying notes to financial statements.

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

For the year ended December 31, 1985		$000	
	1985	1984	1983
Balance, beginning of year	$42,888	$49,551	$47,703
Net earnings (loss) for the year	18,008	(6)	5,924
Share issue expenses, net of tax	–	–	(1,025)
	60,896	49,545	52,602
Dividends			
Class II preferred shares, Series A	259	259	259
Class II preferred shares, Series B	3,260	3,444	–
Class A common shares	3,427	2,908	2,744
Class B common shares	32	46	48
	6,978	6,657	3,051
Balance, end of year	$53,918	$42,888	$49,551

See accompanying notes to financial statements.

AUDITORS' REPORT

Touche Ross & Co.
Suite 2000, 360 Main Street
Winnipeg, Manitoba R3C 3Z3
(204) 942-0051

To the Shareholders,
Federal Industries Ltd.

We have examined the consolidated balance sheet of Federal Industries Ltd. at December 31, 1985 and the consolidated statements of retained earnings, earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Company at December 31, 1985 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Touche Ross & Co.

Chartered Accountants

Winnipeg, Manitoba,
March 7, 1986.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

For the year ended December 31, 1985		$000	
	1985	1984	1983
Operating activities			
Net earnings for the year	$ 18,008	$ (6)	$ 5,924
Depreciation	10,642	9,584	7,092
Amortization	710	614	155
Deferred income taxes	8,576	9,014	2,841
Accrued revenue in respect of deferred income taxes (Note 4)	(2,398)	(2,725)	(2,379)
Gain on sale of fixed assets	(1,670)	(2,907)	(1,504)
Earnings allocated to minority shareholders	654	491	371
Extraordinary item, net of impact on working capital of $5,239	–	9,980	–
Working capital from operations	34,522	24,045	12,500
Accounts receivable	(9,097)	(22,114)	(143)
Inventories	(3,651)	(19,079)	458
Accounts payable and accruals	(5,871)	11,099	945
Other	2,744	(564)	(1,937)
Net cash from (used in) operations	18,647	(6,613)	11,823
Financing activities			
Additional long term debt financing	32,816	9,854	24,859
Decrease in long term debt	(16,221)	(11,455)	(10,415)
Issue of shares (Note 9)	26,551	458	55,170
Long term debt assumed on acquisition of subsidiary companies	4,346	–	61,034
Minority interest in net assets of subsidiaries acquired	–	876	–
Increase in long term receivable net of deferred income tax component of $2,398 (Note 4)	(84)	(706)	(777)
Dividends	(6,630)	(5,783)	(2,854)
Dividends paid by subsidiary company to minority shareholders	(371)	(371)	(371)
Total financing activities	40,407	(7,127)	126,646
Investing activities			
Acquisition of subsidiary companies			
Working capital acquired, excluding cash funds	8,888	(5,904)	(62,918)
Fixed assets acquired	(26,628)	(63)	(48,275)
Other non-current assets acquired	(7,278)	–	(6,787)
Purchase of fixed assets	(17,259)	(11,234)	(8,538)
Proceeds on sale of fixed assets	6,032	4,164	3,337
Other	(4,145)	522	(1,740)
Total investing activities	(40,390)	(12,515)	(124,921)
Increase (decrease) in cash, including $(3,559) (1984 – $1,228; 1983 – $15,672), due to acquisition of subsidiary companies	18,664	(26,255)	13,548
Cash, beginning of year	(18,048)	8,207	(5,341)
Cash, end of year	$ 616	$(18,048)	$ 8,207

Note: Cash represents cash and short term investments, net of bank indebtedness.
See accompanying notes to financial statements.

For the year ended December 31, 1985.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. Principles of consolidation

The consolidated financial statements include the accounts of the Company and all subsidiaries. The names of the principal subsidiaries, which are essentially all wholly owned, are as follows:

Aerospace Group
- Standard Aero Limited
- Standard Aero, Inc.
- Standard Aero (Western) Inc.

Transport Group
- Canadian Motorways Ltd.
- The White Pass and Yukon Corporation Limited
- Thunder Bay Terminals Ltd.

Industrial Distribution Group
- Russelsteel Inc.
- Russelsteel (U.S.A.) Inc.
- Wirth Limited (89.9% owned)
- Wirth Incorporated (89.9% owned)

All material inter-company balances, transactions and profits have been eliminated.

b. Foreign currency translation

The accounts of Wirth Incorporated and of certain subsidiaries of The White Pass and Yukon Corporation Limited are maintained in United States dollars. These accounts represent integrated foreign operations and have been translated into Canadian dollars as follows: current assets, current liabilities and long term debt at exchange rates prevailing at the end of the year; fixed assets and depreciation substantially on the basis of rates prevailing at date of acquisition; income and expenses (other than depreciation) on the basis of average exchange rates during the year. Exchange gains or losses from such translation practices have been included in consolidated earnings.

The accounts of Russelsteel (U.S.A.) Inc. and of certain subsidiaries of Standard Aero Limited are maintained in United States dollars. These accounts represent self-sustaining foreign operations and have been translated into Canadian dollars as follows: assets and liabilities at exchange rates prevailing at the end of the year; income and expenses on the basis of average exchange rates during the year. The adjustment arising from the translation of these accounts has been deferred and included in shareholders' equity as a cumulative translation gain. The adjustment at December 31, 1983 was not material and was included in accounts payable and accrued liabilities.

c. Valuation of inventories

Inventories have been valued at the lower of cost and net realizable value.

d. Capitalization of leases

All material leases of a capital nature have been recorded as fixed assets and long term debt obligations.

e. Revenue recognition – bulk handling terminal contract

A portion of the revenues accruing under the bulk handling terminal contract between Thunder Bay Terminals Ltd. and Ontario Hydro is being recognized on a basis that reflects an approximate constant return over each of the fifteen years of the initial term of the contract. (See Note 4).

f. Depreciation

Depreciation on property, plant and equipment is provided at rates which are estimated to amortize the original cost of such assets over their useful lives.

g. Amortization

Deferred charges are costs related to future revenues and are being amortized over the period that the related revenues are being recognized. Amortization of these items in 1985 was $563,000 (1984 – $474,000; 1983 – $13,000).

Goodwill on the balance sheet represents the excess cost of subsidiary companies over the book amount of net assets acquired, less amounts amortized. Amortization for 1985 was $57,000 (1984 – $51,000; 1983 – $51,000).

Intangible assets include:
(i) $3,815,000 of licences, operating rights and franchises which are not being amortized and, (ii) organizational costs of subsidiary companies, amounts paid for distribution agreements and research materials, which are being amortized over a ten year period. Amortization for these assets in 1985 was $90,000 (1984 – $89,000; 1983 – $91,000).

h. Income taxes

The Company follows the tax allocation method of accounting for income taxes whereby earnings are charged with income taxes relating to reported earnings.

Differences between such taxes and taxes currently payable are reflected in deferred income taxes and arise because of differences between the time certain items of revenue and expense are reported in the accounts and the time they are reported for income tax purposes.

Potential tax reductions that may result from the application of losses against future taxable income are not recognized until recovery out of future taxable income is virtually certain.

i. Basic earnings per share

Earnings per common share are calculated using the weighted daily average number of common shares outstanding. The calculation of fully diluted earnings per share is described in Note 10.

j. International accounting standards

The accompanying financial statements are prepared in accordance with accounting principles generally accepted in Canada and conform in all material respects with international accounting standards.

2. ACQUISITION OF SUBSIDIARY COMPANIES

a. Effective September 27, 1985 the Company, through its subsidiaries, acquired a 100% interest in the Direct Transport System group of companies, a truck transport organization carrying on freight hauling business. Operations of these companies are included in the accounts from the date of acquisition.

This acquisition, which was accounted for by the purchase method, is included in the Transport Group and is summarized as follows:

	$000
Net assets acquired at fair market values at acquisition date:	
Current assets	$15,074
Current liabilities	27,521
Working capital, including bank indebtedness of $3,559	(12,447)
Fixed assets	26,628
Other non-current assets	7,278
	$21,459
Consideration:	
Cash	$17,113
Long term debt assumed	4,346
	$21,459

b. In January 1986, the Industrial Distribution Group of the Company acquired I. Bahcall Steel & Pipe Inc., a general line steel service centre operator serving Wisconsin and Minnesota, for approximately U.S. $5 million.

3. INVENTORIES

		$000	
	1985	1984	1983
Aerospace	$ 63,524	$ 54,930	$ 37,716
Transport	10,568	9,418	12,516
Industrial Distribution	68,595	71,458	55,027
	$142,687	$135,806	$105,259

4. TERMINAL HANDLING FACILITIES — THUNDER BAY, ONTARIO

a. Coal handling facility

Thunder Bay Terminals Ltd. has entered into a long term contract with Ontario Hydro for the construction and operation of a bulk terminal handling facility at Thunder Bay, Ontario. The total original cost of the terminal was $69,851,000 of which $53,953,000 relates to facilities which became operational on March 1, 1979 and $15,898,000 relates to terminal facilities which became operational in 1981.

The cost of the terminal has been financed by the issue of $71,496,000 aggregate principal amount, 9⅝% First Mortgage Sinking Fund Bonds, Series A. As at December 31, 1985, the Series A bonds issued and outstanding aggregated $48,904,000. The terms and conditions of the Series A bond issue are provided for in a Deed of Trust and Mortgage dated as of October 12, 1977 between Thunder Bay Terminals Ltd. and the trustee for the bondholders.

Under the terms of the agreements with Ontario Hydro, Thunder Bay Terminals Ltd. will receive, over the initial fifteen year term of the contract, contractual amounts of revenue including specific revenue components to cover all payments required for the redemption of all of the Series A bonds and for income taxes. These revenue components become recoverable as and when the bond and income tax payments become due and payable. The use of the cash received in respect of these specific revenue components is restricted to the redemption of the Series A bonds and the payment of income taxes.

The amounts receivable over the fifteen years of the initial term of the contract to cover the redemption of the Series A bonds represent the revenues required to pay for the capital cost of the terminal facility. The net contribution to earnings from these revenues (total amounts receivable less depreciation on the terminal) is recorded in the accounts so as to reflect an approximate constant annual return over each of the fifteen years.

At December 31, 1985, the net accrued revenues receivable from Ontario Hydro for the redemption of Series A bonds amount to $7,342,000 of which $3,492,000 is long term and $3,850,000 is current. The long term accrued revenues receivable for the payment of income taxes amount to $15,969,000 (1984 – $13,561,000; 1983 – $10,837,000), all of which relate to deferred income taxes. Because the $15,969,000 to be received is restricted to the payment of income taxes, the liability for the deferred income taxes has been netted against the long term receivable.

b. Potash handling facility

On September 16, 1983, Thunder Bay Terminals Ltd. entered into agreements with Canadian Pacific Limited for (i) the management and supervision of the construction of a dry bulk handling facility; and (ii) an exclusive license to operate the facility. The initial term of the potash handling agreement commenced upon completion of construction of the dry bulk handling facility on April 1, 1984 and is scheduled to terminate on February 28, 1994.

5. FIXED ASSETS

	$000				
	1985			1984	1983
	Cost	Accumulated Depreciation	Net	Net	Net
Aerospace					
Land and buildings	$ 8,161	$ 2,427	$ 5,734	$ 2,323	$ 3,699
Machinery and equipment	16,120	6,510	9,610	4,490	2,210
	24,281	8,937	15,344	6,813	5,909
Transport					
Land and buildings	113,271	36,838	76,433	78,557	82,586
Machinery and equipment	77,892	42,061	35,831	19,084	42,365
Assets held for sale	20,558	–	20,558	14,762	2,365
	211,721	78,899	132,822	112,403	127,316
Industrial Distribution					
Land and buildings	13,846	2,017	11,829	13,083	13,529
Machinery and equipment	9,326	792	8,534	7,475	7,296
	23,172	2,809	20,363	20,558	20,825
Other corporate assets	1,931	429	1,502	1,179	220
	$261,105	$ 91,074	$170,031	$140,953	$154,270

Included in the amounts reported above are assets under capital leases of $6,425,000 (1984 – $3,623,000; 1983 – $4,833,000) and related accumulated depreciation thereon of $1,579,000 (1984 – $1,784,000; 1983 – $2,089,000).

6. LONG TERM DEBT

	$000		
	1985	1984	1983
Aerospace			
Bank loan (Note 7)			
13.18%-13.43%, due 1990	$ 6,987	$ 6,618	$ 6,222
Other	34	–	49
	7,021	6,618	6,271
Transport			
Thunder Bay Terminal			
First mortgage bond, 9⅝% (Note 4)	45,054	48,904	52,754
Promissory note, secured, 15%, 1986 to 1987	700	1,280	–
Capitalized leased obligations, 8.2%-14.4%	1,891	1,288	1,785
Government of Canada non-interest bearing loan, secured by certain rail assets	4,250	4,500	4,750
Alaska Industrial Development Authority Port Facility 13¾% bond, 1985 to 1998	4,493	4,697	4,368
Mortgages, 10⅝%-12½%, 1985 to 1988	2,593	3,243	3,409
Bank loan, ½% above U.S. prime rate	–	178	403
Bank loan, ¼% above prime rate	–	6,400	9,000
Other	5	30	6
	58,986	70,520	76,475
Industrial Distribution			
Industrial Development Bond, 7½%	1,118	1,189	1,245
Note payable, 12.36%, due 1988	–	55,000	55,000
Note payable, 19%, due 1994	6,150	6,150	–
Mortgages, 7¾%-8%	–	60	623
Capitalized lease obligations	–	79	124
	7,268	62,478	56,992
Corporate debt (Note 7)			
Bank loan, 11.15%-11.48%, 1988-1992	55,000	–	–
Bank loan, 11.79%-11.92%, due 1992	10,520	–	–
Bank loan, 11.79%-11.92%, due 1986	9,888	–	–
Bank loan, 11.77%, due 1986	4,800	–	–
Bank loan, 13.18%-13.43%, due 1990	6,987	6,618	6,222
Bank loan, 11.85%, due 1987	6,987	–	–
Note payable	–	165	220
Capitalized lease obligations, 14.25%-16.5%	73	93	131
	94,255	6,876	6,573
	$167,530	$146,492	$146,311

Interest on the corporate debt bank loans is calculated subject to the terms of interest rate conversion agreements extending from various dates up to 1995. Loans maturing from time to time are expected to be refinanced over the remaining terms of the interest rate conversion agreements.

The aggregate amount of maturities for each of the five years following the balance sheet date is as follows;

	1985	1984	1983
1984			$ 6,818
1985		$ 6,271	17,326
1986	$ 6,652	6,231	5,371
1987	13,716	6,192	5,205
1988	29,345	60,337	67,199
1989	8,546	4,804	
1990	42,463		

7. BANK INDEBTEDNESS

At December 31, 1985, the Company's bank indebtedness and term loans with its bankers were secured by the pledge of certain assets and debentures. Effective January 16, 1986 the Company renegotiated such bank indebtedness and term loans to be on an unsecured basis.

8. MINORITY INTEREST

Minority interest is $5,500,000 of 6¾% preferred shares of The White Pass and Yukon Corporation Limited (1984 – $5,500,000; 1983 – $5,500,000), and $1,274,000 of common equity of Wirth Limited and Wirth Incorporated (1984 – $996,000).

9. SHARE CAPITAL

a. At December 31, 1985 the authorized share capital of the Company consists of:

i. an unlimited number of Class A convertible common shares without nominal or par value;

ii. an unlimited number of Class B convertible common shares without nominal or par value;

iii. an unlimited number of Class I preferred shares without nominal or par value, issuable in series; and

iv. an unlimited number of Class II preferred shares without nominal or par value, issuable in series; to date the directors have authorized:

28,760 Convertible Class II preferred shares, Series A, with annual cumulative cash dividends of $9.00 per share payable in quarterly instalments. These shares are convertible on or before May 20, 1992 on the basis of approximately 12.674 Class A common shares for each Class II preferred share, Series A.

1,600,000 $2.0625 Cumulative Redeemable Convertible Class II preferred shares, Series B, with annual cash dividends of $2.0625 per share payable in quarterly instalments. This series of Class II preferred shares is redeemable subject to certain conditions being met at prices ranging from $26.25 per share in 1986 to $25.00 per share in 1993 and thereafter. These shares are convertible on or before the earlier of December 15, 1990 and the date fixed for redemption on the basis of approximately 2.74 Class A common shares for each Class II preferred share, Series B.

Both the Class A common shares and the Class B common shares are interconvertible at any time at the option of the holder on a share for share basis. The basic difference between the two classes of shares is that dividends on Class A common shares are payable in the form of cash dividends, while dividends on Class B common shares are presently payable in the form of stock dividends, payable in Class B common shares.

The directors have the authority to issue the Class I and Class II preferred shares in series and fix the designation, rights, privileges and conditions to be attached to each series, except the Class I shares shall be entitled to preference over the Class II shares with respect to the payment of dividends and the distribution of assets in the event of liquidation, dissolution or winding-up of the Company.

b. During 1985 the following shares were issued:
i. 202,379 Class A common shares on conversion of 73,862 Class II preferred shares, Series B originally issued for $1,846,000;
ii. 221,000 Class A common shares for an aggregate consideration of $1,398,000 under the terms of the share option plan;
iii. 2,300,000 Class A common shares for an aggregate consideration of $25,117,000, net of after tax expenses of $758,000; and
iv. 3,430 Class B common shares as stock dividends of $36,000, of which $11,000 was accrued in 1984; an additional 373 Class B shares were issued as stock dividends of $7,000 on January 1, 1986.

c. The number of shares issued and outstanding at December 31 was as follows:

	1985	1984	1983
Class II preferred, Series A	28,760	28,760	28,760
Class II preferred, Series B	1,525,638	1,599,500	1,600,000
	1,554,398	1,628,260	1,628,760
Class A common*	14,498,999	11,658,456	11,577,454
Class B common*	58,968	172,702	196,968
	14,557,967	11,831,158	11,774,422

*Effective August 28, 1985, the Company's common shares were split on a 2 for 1 basis. The issued common shares for 1984 and 1983 have been restated to reflect this split.

d. The recorded values of the shares issued and outstanding at December 31 were as follows:

		$000	
	1985	1984	1983
Class II preferred			
Series A	$ 2,876	$ 2,876	$ 2,876
Series B	38,141	39,987	40,000
Common shares	73,700	45,303	44,786
	$114,717	$88,166	$87,662

e. In 1978, the shareholders confirmed a by-law authorizing a stock purchase plan, the purpose of which is to provide loans to employees of the Company and subsidiary companies for the purchase of Class A common shares of the Company. To date, 50,000 shares have been issued to an officer of the Company and an officer of a subsidiary company at their market value for an aggregate consideration of $458,000.

f. In December 1981, the directors approved a share option plan, the purpose of which is to provide employees of the Company and its subsidiaries with the opportunity to participate in the growth and development of the Company. At any time, 10% of the authorized and unissued Class A common shares of the Company are reserved and set aside for purposes of the stock purchase and share option plans. The options are exercisable on a cumulative basis to the extent of 20% per year of total options granted, except that under certain specified conditions the options become exercisable immediately. Details of options granted to officers of the Company and its subsidiaries are as follows:

Year of Issue	Number of shares	Exercise Price	Exercisable Per Year	Exercisable To Date	Year of Expiry
1981	163,000	6.34375	32,600	163,000	1991
1983	20,000	6.2500	4,000	12,000	1993
1983	20,000	5.7559	4,000	12,000	1993
1984	26,000	8.455	5,200	10,400	1994
1985	512,500	12.125	102,500	102,500	1991-1995
	741,500		148,300	299,900	

On January 3, 1986, 175,000 Class A common shares of the Company were issued for an aggregate consideration of $1,125,000.

10. EARNINGS PER COMMON SHARE

a. Basic earnings per common share are calculated using the weighted daily average number of common shares outstanding.

b. Fully diluted earnings per common share are as follows:

	1985	1984	1983
Fully diluted earnings per share before extraordinary item	$1.05	$ .92	$ .51
Extraordinary loss on write-down of rail assets	–	N/A	–
Fully diluted earnings (loss) per share after extraordinary item	$1.05	$(.30)	$ .51

Fully diluted earnings per share are calculated under the assumption that all convertible preferred shares were converted at the beginning of the year and that stock options outstanding during the year had been exercised at the beginning of the year, or when granted. Imputed earnings on the proceeds from the exercise of the options and the net dividend saving on the conversion of preferred shares of $556,846 were calculated using a 12.37% after tax rate of return.

The 1984 and 1983 per share figures have been adjusted to reflect the 2 for 1 stock split which took place August 28, 1985.

11. INCOME TAXES

a. The Company's effective income tax rates are derived as follows:

	1985	1984	1983
Average combined tax rate	50.0%	49.8%	51.1%
Dividend income	(2.9)	(2.9)	–
Inventory tax allowances	(5.5)	(5.7)	(5.6)
Reduced rate on capital gains	(1.7)	(0.6)	(5.3)
Unrecorded tax benefits related to losses of subsidiary companies	0.8	1.6	3.3
Manufacturing and processing tax credits	(0.2)	–	(1.3)
Investment tax credits (b)	–	(2.7)	(0.3)
Other	(1.0)	(0.1)	3.2
Average effective tax rate	39.5%	39.4%	45.1%

b. In 1985, the Company adopted the cost reduction method of accounting for investment tax credits and accordingly such credits do not affect the effective tax rate for 1985.

c. Certain subsidiaries of the Company have tax loss carry forwards of approximately $3,468,000 and investment tax credit carry forwards of approximately $1,317,000 available to reduce future taxable income and taxes payable. The potential benefits of these carry forwards will be recorded as the benefits are received.

12. SEGMENTED INFORMATION

a. The Company has segmented its operations on the basis of the major industries in which it operates as described below:

i. The Aerospace Group's operations consist of the remanufacturing and rebuilding of aircraft engines, the distribution of aviation parts and accessories, and airframe repair and modification.

ii. The Transport Group's operations consist of the distribution of petroleum and related consumer products, the provision of truck transportation services including the moving of oil drilling rigs, and the operation of major bulk handling terminal facilities.

iii. The Industrial Distribution Group's operations consist of the distribution of general line, flat-rolled and specialty steel products, metals trading, and the distribution of industrial valves, piping components and related products.

b. The Aerospace Group had domestic sales to foreign customers, principally in Europe, of $11,790,000 (1984 – $9,118,000; 1983 – $7,354,000).

	1985	$000 1984	1983
Sales & Services			
Aerospace	$139,681	$104,043	$ 90,880
Transport	194,092	160,511	112,918
Industrial Distribution	385,265	308,037	–
	$719,038	$572,591	$203,798
Segment Margin			
Aerospace	$ 7,343	$ 5,003	$ 4,006
Transport	24,249	23,103	17,699
Industrial Distribution	21,378	18,121	–
	52,970	46,227	21,705
Interest expense	(21,230)	(20,034)	(9,744)
Investment income	2,607	2,503	984
Other corporate expenses	(3,493)	(2,801)	(1,474)
Earnings from operations	30,854	25,895	11,471
Provision for income taxes	(12,192)	(10,191)	(5,176)
Allocated to minority shareholders	(654)	(491)	(371)
Extraordinary item	–	(15,219)	–
Net earnings (loss)	$ 18,008	$ (6)	$ 5,924
Capital Expenditures			
Aerospace	$ 10,009	$ 1,781	$ 2,175
Transport	32,150	7,587	33,766
Industrial Distribution	1,302	907	20,825
Other corporate assets	426	1,022	47
	$ 43,887	$ 11,297	$ 56,813
Depreciation and Amortization			
Aerospace	$ 1,425	$ 1,061	$ 1,006
Transport	7,884	7,338	6,192
Industrial Distribution	1,934	1,734	–
Other corporate assets	109	65	49
	$ 11,352	$ 10,198	$ 7,247
Identifiable Assets			
Aerospace	$120,864	$ 90,532	$ 66,950
Transport	200,852	160,733	177,426
Industrial Distribution	157,227	169,477	112,793
Other corporate assets	49,934	28,990	19,800
	$528,877	$449,732	$376,969

13. EXTRAORDINARY ITEM

	$000 1985	1984
Write down of railway and related assets and provision for costs of continued suspension of railway operations, net of deferred income taxes of $4,191,000	$ –	$15,219

14. CONTINGENCIES AND COMMITMENTS

a. The Company has an investment of $2,157,000 (1984 – $2,150,000; 1983 – $1,650,000) in preferred shares of and loans to a company that is highly leveraged, with substantially all of its debt repayable on demand. Although its lenders have not indicated their intent to demand repayment, should such an event occur it is unlikely that it would be able to meet such repayment demand. In these circumstances, liquidation could result and the Company could suffer a loss on its investment.

b. The Company and its subsidiary companies have operating lease commitments with varying terms requiring annual rental payments of approximately $4,420,000 (1984 – $2,715,000; 1983 – $686,000).

15. OTHER

a. At December 31, 1985, loans to officers of the Company represented housing loans of $232,000 (1984 – $244,000; 1983 – $256,000) and loans under the stock purchase plan of $270,000 (1984 – $274,000; 1983 – Nil).

b. Certain of the prior years' figures have been restated to reflect the current year's presentation.

Accounting for the Effects of Inflation (Unaudited)

The audited financial statements in this Annual Report are based on historical cost accounting, which matches actual costs incurred with actual revenues received. To highlight the effect of inflation on financial assets of the business, the Canadian Institute of Chartered Accountants (CICA) has recommended that corporations provide supplemental information to show the effect of inflation on the balance sheet and results of operations for the year. The primary focus is upon specific changes in prices of assets and in expenses associated with the use of fixed assets or the sale of inventories. It is a method of measuring their current values in terms of what the assets would cost to purchase or produce at the balance sheet date or at the date of use of fixed assets or sale of goods produced.

Current cost accounting amounts for the Company's assets were determined for the most part by using appropriate specific indices or reliable market prices. For property, plant and equipment this method assumes the assets would be replaced with like technology, although this would not always be the case. The current cost of sales was determined by adjusting the historical costs by the estimated specific price changes which occurred between the time of production and the time of sale.

This method of reporting requires the use of numerous assumptions and estimates, and accordingly, the resulting information, presented below, is not a precise indication of the effects of inflation on the results of your Company. In addition, the provision for income taxes, according to the CICA recommendations, remains unchanged, since adjustments to income under the current cost computations are not deductible for tax purposes. This results in a tax rate which is considerably higher than normal. Accordingly, management feels that the pretax comparison of operating results on an historic and current cost basis is more meaningful than the net of tax amounts.

The current cost profit of $9.8 million for 1985, as shown in the schedule below, is based on an operating capability concept of capital. This concept measures income and loss generated by an enterprise from all sources of capital, whether provided by lenders or shareholders. To measure income attributable to shareholders on a current cost basis, the CICA recommends the calculation of a "financing adjustment". It is based on the supposition that the funds required to maintain a company's operating capability (replace the assets it consumes) will be provided by a combination of shareholder and borrowed funds. The financing adjustment aims to provide a measure of the increases in current costs that would be financed by debt. Recognizing this adjustment increased the inflation-adjusted profit by $1.2 million.

Two items of general inflation information are presented. The first "Excess of increase in current cost over the effect of general inflation" provides a comparison of the specific price change adjustments and changes that would have resulted from general inflation level application. This differential was $1.9 million for 1985. The second is "General purchasing power gain on net etary liabilities". Holders of cash and other monetary assets lose purchasing power during periods of inflation — "debtor's gain". Your Company has greater monetary liabilities than monetary assets and the general purchasing power gain thereon helps preserve the general purchasing power of the shareholders' equity. On the CICA basis of calculation, which excludes deferred income taxes as a monetary item, your Company would have reported a net gain in purchasing power of approximately $5.7 million.

As a final item of disclosure, we present a comparative schedule of consolidated assets on the basis of current and historical costs. This table shows there is an apparent increase in common shareholders' equity from historical to current cost accounting of $13.7 million.

In arriving at the foregoing estimates, judgment has been exercised with respect to the treatment of certain asset groups. For example, in the case of Thunder Bay Terminals, no adjustment has been made for the incremental cost of replacing assets, since funding is covered on a "current cost" basis with Ontario Hydro, the company's principal customer.

Despite the obvious weaknesses inherent in estimating and the apparent anomalies, as with tax rates, your Company supports the disclosure of inflation accounting information to enable readers of the financial statements to obtain a more informed assessment of the Company's results.

CONSOLIDATED STATEMENT OF EARNINGS ON A CURRENT COST BASIS

Under an Operating Capability Concept of Capital for the year ended December 31, 1985

	$000		
	Historical	Current Cost	
	1985	1985	1984*
Sales and services	$719,038	$719,038	$597,506
Cost of sales and operating expenses	659,879	663,167	546,784
Depreciation	10,642	11,517	10,752
Amortizaton	710	710	641
Interest on long term debt	17,168	17,168	17,820
Other interest expense	4,062	4,062	3,086
Investment income	(2,607)	(2,607)	(2,612)
Gain on sale of fixed assets	(1,670)	–	–
	688,184	694,017	576,471
Earnings on a current cost basis before income taxes	30,853	25,021	21,035
Provision for income taxes			
Current	3,616	3,616	1,228
Deferred	8,576	8,576	9,406
	12,192	12,192	10,634
Net earnings on a current cost basis before extraordinary item	18,662	12,829	10,401
Extraordinary item	–	–	15,881
Net earnings (loss)	18,662	12,829	(5,480)
Earnings allocated to minority shareholders	654	654	512
Net earnings (loss) on a current cost basis for the year	18,008	12,175	(5,992)
Financing adjustment	–	1,174	2,664
Dividends on preferred shares	(3,519)	(3,519)	(3,864)
Net earnings (loss) attributable to common shareholders on a current cost basis under an operating capability concept of capital	$ 14,489	$ 9,830	$ (7,192)

Based on the current cost adjustments made to income during the year the financing adjustment amounts to $3,089,000 (1984* – $3,255,000). *Comparative data for 1984 has been restated into 1985 dollars.

REPORTING THE EFFECTS OF CHANGING PRICES

Supplementary Information
for the year ended December 31, 1985

	$000	
	1985	1984*
Increase in current cost amounts of inventory and property, plant and equipment	$2,218	$ 5,093
Effect of general inflation	356	2,921
Excess of increase in current cost over the effect of general inflation	$1,862	$ 2,172
General purchasing power gain on net monetary liabilities	$5,693	$ 4,623

Schedule of Consolidated Assets on a Current Cost Basis

	$000		
	Historical	Current Cost	
	1985	1985	1984*
Inventory	$142,687	$144,698	$144,182
Property, plant and equipment – net	$170,031	$181,742	$148,248
Net assets (common shareholders' equity)	$130,097	$143,820	$ 96,868

*Comparative data for 1984 has been restated into 1985 dollars.

SEGMENTED INFORMATION

($000)	Aerospace Group		
	1985	1984	1983
Sales	$144,894	$109,412	$ 97,935
Inter segment sales	5,213	5,369	7,055
	139,681	104,043	90,880
Segment operating profit before interest and taxes	7,343	5,003	4,006
Investment income			
Interest expense			
Inter segment interest			
General corporate expenses			
Earnings from operations before income taxes			
Income taxes			
Net earnings before minority interest and extraordinary item			
Identifiable assets	120,864	90,532	66,950
Corporate assets			
Industrial Distribution*			
Total assets			
Capital expenditures	10,009	1,781	2,175
Depreciation and amortization	1,425	1,061	1,006

*Industrial Distribution Group was acquired December 31, 1983.

Industrial Distribution		Transport Group			Consolidated		
1985	1984*	1985	1984	1983	1985	1984	1983
$390,811	$310,868	$194,092	$160,965	$115,005	$729,797	$581,245	$212,940
5,546	2,831	–	454	2,087	10,759	8,654	9,142
385,265	308,037	194,092	160,511	112,918	719,038	572,591	203,798
21,378	18,121	24,249	23,103	17,699	52,970	46,227	21,705
					2,607	2,503	984
					(30,871)	(25,058)	(12,583)
					9,641	5,024	2,839
					(3,493)	(2,801)	(1,474)
					30,854	25,895	11,471
					12,192	10,191	5,176
					$ 18,662	$ 15,704	$ 6,295
157,227	169,477	200,852	160,733	177,426	478,943	420,742	244,376
					49,934	28,990	19,800
							112,793
					$528,877	$449,732	$376,969
1,302	907	32,150	7,587	33,766			
1,934	1,734	7,884	7,338	6,192			

CONSOLIDATED HISTORICAL SUMMARY

For the twelve months ended	31 Dec. 85	31 Dec. 84	31 Dec. 83	31 Dec. 82
Income Information ($000)				
Sales and services	719,038	572,591	203,798	179,193
Gross earnings from operations	59,159	50,717	25,974	25,870
Net earnings before extraordinary items	18,008	15,213	5,924	6,029
Extraordinary items	–	(15,219)	–	–
Net earnings after extraordinary items	18,008	(6)	5,924	6,029
Depreciation	10,642	9,584	7,092	7,159
Interest on long term debt	17,168	17,077	8,427	6,760
Income taxes	12,192	10,191	5,176	5,004
Earnings (loss) per Common Share ($)	1.17	(0.30)	0.51	0.63
Earnings (loss) per Common Share excluding extraordinary items ($)	1.17	0.99	0.51	0.63
Balance Sheet Information ($000)				
Current assets	334,876	290,675	206,852	85,238
Current liabilities	170,430	153,300	80,378	34,696
Working capital	164,446	137,375	126,474	50,542
Fixed assets – Net	170,031	140,953	154,270	106,384
Other assets	23,970	18,104	15,847	7,947
Total assets	528,877	449,732	376,969	199,569
Long term debt	167,530	146,492	146,311	71,895
Deferred income taxes	13,029	11,215	7,567	7,342
Minority interest	6,774	6,496	5,500	5,500
Shareholders' equity	171,114	132,229	137,213	80,136
Other Information				
Gross margin ratio %	8.2	8.9	12.7	14.4
Return on equity %	16.2	12.4	7.1	7.8
Debt/equity ratio	.88	.98	.97	.77
Current ratio	1.96	1.90	2.57	2.46
Net earnings before extraordinary items as % of sales	2.5	2.7	2.9	3.4
No. Common Shares outstanding (A&B)	14,557,967	11,831,158	11,774,422	9,389,226
Dividend per Share				
Class A ($) Note 1	.2625	.25	.25	.225
Class B ($) Note 2	.2625	.25	.25	.225
Price range of stock ($)				
High	14.00	10.38	8.25	7.00
Low	9.63	8.00	5.19	4.13
Shareholders' equity per Common Share ($)	8.94	7.55	8.01	8.23

NOTES: (1) Payable in cash dividends.

(2) Payable by way of stock dividend in Class B Shares. These Class B Shares were created in May, 1980.

31 Dec. 81	31 Dec. 80	31 Dec. 79	31 Dec. 78*	31 Mar. 78	31 Mar. 77
192,690	159,226	126,716	112,987	99,830	78,848
35,736	29,264	18,173	11,293	7,779	7,095
10,914	7,407	1,789	714	(17)	591
24	(290)	–	(1,527)	(2,498)	891
10,938	7,117	1,789	(813)	(2,515)	1,482
6,649	5,615	5,227	3,974	3,431	3,743
6,503	8,319	7,969	3,120	1,074	1,267
10,462	7,158	1,756	1,475	1,611	573
1.22	0.99	.26	(.12)	(.37)	.22
1.22	1.03	.26	.11	(.01)	.09
91,084	69,032	56,490	50,044	49,039	52,508
51,036	44,805	41,880	39,386	44,618	42,457
40,048	24,227	14,610	10,658	4,421	10,051
109,974	102,250	119,092	112,574	98,398	60,369
5,246	7,965	16,135	13,347	7,635	5,840
206,304	179,247	191,717	175,965	155,072	118,717
68,313	68,853	95,043	82,542	59,396	22,034
6,500	5,079	5,525	6,091	5,744	5,193
5,500	5,500	5,500	5,500	5,500	5,500
74,955	55,010	43,769	42,446	39,814	43,533
18.5	18.4	14.3	10.0	7.8	9.0
19.8	16.9	4.2	1.6	–	1.4
.79	1.05	1.73	1.53	1.16	.41
1.78	1.54	1.35	1.27	1.10	1.24
5.7	4.7	1.4	.6	–	.7
9,579,548	7,888,012	7,057,800	6,977,800	6,877,800	6,877,800
.1375	.10	.10	.10	.18	.20
.1375	.10	–	–	–	–
7.94	7.63	4.00	3.56	4.00	3.00
5.00	3.19	2.75	2.45	2.45	2.40
7.83	6.98	6.20	6.09	5.79	6.62

*Unaudited

SUMMARIZED QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

	Three months ended				Year ended
1985	March 31	June 30	Sept. 30	Dec. 31	Dec. 31
Sales ($000)	156,077	179,384	187,478	196,099	719,038
Gross earnings from operations ($000)	9,973	15,975	17,715	15,496	59,159
Gross margin percentage	6.4%	8.9%	9.4%	7.9%	8.2%
Net earnings* ($000)	1,906	5,273	5,754	5,075	18,008
Earnings per Common Share*	$0.09	$0.37	$0.41	$0.30	$1.17
Market price of Common Shares					
High	11.25	12.50	13.50	14.00	14.00
Low	9.62	9.87	11.00	11.00	9.62
Number of Common Shares traded	626,640	1,157,040	1,870,887	1,562,960	5,217,527

	Three months ended				Year ended
1984	March 31	June 30	Sept. 30	Dec. 31	Dec. 31
Sales ($000)	114,556	128,133	164,913	164,989	572,591
Gross earnings from operations ($000)	8,376	12,911	15,197	14,233	50,717
Gross margin percentage	7.3%	10.1%	9.2%	8.6%	8.9%
Net earnings* ($000)	1,386	3,717	5,298	4,812	15,213
Earnings per Common Share*	$0.04	$0.24	$0.37	$0.34	$0.99
Market price of Common Shares					
High	9.00	9.44	10.38	10.13	10.38
Low	8.00	8.31	9.00	9.00	8.00
Number of Common Shares traded	659,090	437,600	361,644	627,258	2,085,592

	Three months ended				Year ended
1983	March 31	June 30	Sept. 30	Dec. 31	Dec. 31
Sales ($000)	34,307	41,357	42,356	85,778	203,798
Gross earnings from operations ($000)	2,530	6,406	6,248	10,790	25,974
Gross margin percentage	7.4%	15.5%	14.8%	12.6%	12.7%
Net earnings* ($000)	(1,817)	1,770	2,308	3,663	5,924
Earnings per Common Share*	$(0.20)	$0.17	$0.22	$0.32	$0.51
Market price of Common Shares					
High	6.75	7.50	8.25	8.25	8.25
Low	5.19	6.56	7.25	7.25	5.19
Number of Common Shares traded	722,200	1,344,800	464,200	149,000	2,680,200

*Before extraordinary items

GOVERNMENT REGULATION

ECONOMIC NECESSITY OR IMPEDIMENT TO GROWTH? AN ASSESSMENT AS CANADA MOVES TOWARD FREER ENTERPRISE.

A QUICK HISTORY OF REGULATION

The controversy surrounding government regulation has a long history. In 1776, Adam Smith wrote in *Wealth of Nations:*

"It is the highest impertinence and presumption . . . in kings and ministers, to pretend to watch over the economy of private people . . . they are themselves always, and without exception, the greatest spendthrifts in the society."

Smith was an Englishman who recognized a vital role for government in maintaining social order. But his vision of what could be accomplished by unfettered free enterprise suggested that even well-intended government intervention in the economy did more harm than good. His work became a cornerstone of economic philosophy in the United States, a nation that was founded the year his book was first published. Since then, the United States has been a testing ground for new theories of business but has always maintained its commitment to the value of a free-market economy.

Even in that bastion of free enterprise, however, the traditional cast of characters on the business stage — manager, owner, shareholder, employee and customer — has been expanded in recent years to include an additional player: the regulator. In both Canada and the U.S., the government's role in imposing social regulations governing safety, health, education and the environment has grown to include massive economic regulation as a means of controlling the marketplace.

". . . though the profusion of government must, undoubtedly, have retarded the natural progress of England towards wealth and improvement, it has not been able to stop it." ADAM SMITH

While regulations of one kind or another have always been with us, they have come into unprecedented use over the past quarter-century with the emergence of the welfare state. The first modern regulatory body was actually created almost 100 years ago. In 1887, the Interstate Commerce Commission was created in the U.S. to control railways that were practising tariff discrimination. It was the first of many such boards, commissions and tribunals that ultimately proliferated throughout North America and played a major role in shaping our present economic system.

WHAT REGULATION IS ALL ABOUT

Government regulations are rules for the conduct of society's affairs that have the force of law.

One kind of regulation attempts to alter market forces in order to modify prices, supply, income distribution, and so forth. Examples of this kind of regulation are numerous: rent control, the short-lived and unlamented National Energy Policy, dairy quotas, and many others. The rationale behind this type of economic regulation is government's view that, left to itself, the market will produce results that are contrary to implicit or explicit economic, social, or national objectives.

This type of economic regulation is usually initiated by lobbies that would benefit from it, without much concern for economic efficiency. Quite often, in fact, greater inefficiency is considered to be an acceptable price to pay in order to achieve some other good, such as higher employment, greater economic sovereignty, increased opportunity for a disadvantaged minority group, and so forth.

The second type of regulation attempts to correct imbalances in the market such as those that might arise from natural monopolies and other economic forces. When the government feels that the existing competitive forces will lead to the organization of an industry in a manner which is undesirable for the economy as a whole, regulations are imposed to stem the tide.

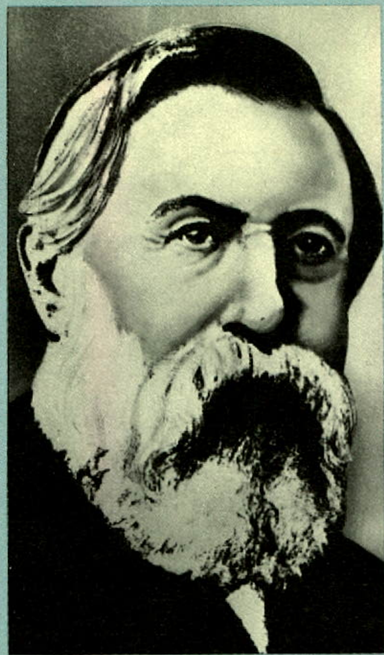
In the United States, elaborate anti-trust regulations were imposed, initially upon railroads and later upon industry in general, to prevent companies such as General Motors, IBM and Kodak from securing a monopoly position. The regulators believe that such companies would be able to exploit their economic advantage to the detriment of consumers.

For several decades, government regulation has been seen as a fundamental tool for managing the economy. Since the mid-1970s, however, the trend has reversed. Economic regulation has been increasingly challenged from many quarters. In the United States, President Gerald Ford initiated regulatory reform with little success, largely because of fierce opposition from industry. President Jimmy Carter managed to achieve deregulation in the transportation industry during his presidency, and Ronald Reagan has continued the drive toward deregulation.

"With our widely-dispersed population and our distance to markets, transportation charges are a major cost component of the products we sell at home and abroad. So it is obvious that we require an even more efficient and productive transportation system in order to meet the competitive realities of the 1980s." DON MAZANKOWSKI

DEREGULATION IN CANADA

In 1978, the provincial premiers gave the Economic Council of Canada a mandate to study regulation and to propose policy options. The Council began an extensive review of the economic consequences of regulation. Leading academic authorities participated, as did public servants from the Department of Transport, the Ministry of Consumer Affairs and the Canadian Transport Commission. The 1981 Economic Council Report *Reforming Regulation* was the result. Since its publication, a federal agreement on trucking deregulation has been signed, and efforts have been made to deregulate some areas of the airline and energy industries.



"Competition is the most extreme expression of that war of all against all which dominates modern middle-class society." FRIEDRICH ENGELS

THE PROS AND CONS OF DEREGULATION

The life styles of the "robber barons" who built enormous wealth during the Industrial Revolution led, rightly or wrongly, to the perception that wealth was accumulated on the backs of the poor — an unacceptable circumstance in a land where all were presumed to be created equal. It was believed to be the right and duty of governments to correct what were clearly flagrant abuses of monopoly power through regulation. While creating effective regulations proved to be a challenge, the worst abuses — exploitation of child labour, unsafe working conditions, and the like — were largely corrected. Regulation was considered to be a good thing, not only by society at large, but, in many cases, by the regulated themselves.

While it has long been fashionable for business to protest government interference, many regulations have been authored by the businesses being regulated or by their lobbyists. In some cases, these regulations have served their defined purposes admirably, offering the secondary benefit of maintaining attractive profit margins in defined markets.

In the 1980s, many economists and political leaders recognize that interventionism has often failed to fulfill its promise. Three recessions and two bouts of inflation since 1974 — combined with continuing high unemployment — have severely challenged the belief that economic policy can "fine-tune" the business cycle. In many instances, market

"The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries." WINSTON CHURCHILL

participants were able to circumvent regulation legally; in others, regulation often succeeded in restricting desirable economic activity rather than forcing markets to conform with the wishes of the regulators.

For example, enforcement of trucking regulations has been a deterrent to illegal trucking but it has also induced shippers to use their own fleets instead of contracting "for-hire" trucking. In many cases, the result was an increase in the number of trucks running down the road empty. By the same token, attempts to impose labour legislation and other regulations on sea transport on a national basis have often resulted in shipping companies taking their business to Third World countries offering "flags of convenience".

Once these shortcomings were realized, the instinctive reaction of the legislator was to try to tighten regulations and to close the loopholes. Usually, this proved to be wishful thinking as market participants showed greater ingenuity in adapting than government did to changing the rules of the game. The consequence was that many industries and whole economic sectors became buried in red tape, resulting in even more restriction of business activity.

As a result, the government's role in economic regulation has come under close scrutiny in recent years. Advocates of less government intervention point out that not only has regulation failed to accomplish what it was intended to do, but also that it has produced undesirable side effects. In their opinion, regulations tend to be inflexible, lagging behind the many subtle structural changes taking place within the economy. In the manufacturing sector, for example, regulation tends to slow down the rate of technological innovation, at least in the short-term — particularly in protected markets, because optimum productivity is not required in order to compete.

Where regulation restricts competition in order to protect market share, the result is inefficiency — products and services that are more expensive and of poorer quality than those produced in a competitive market. When prices or rates are established on a "cost-plus" basis, these inefficiency factors, and the resulting ability of suppliers of vital services and resources to increase their prices, encourage the growth of inflation.

"The business of government is to keep the government out of business — that is, unless business needs government aid." WILL ROGERS

Regulation can cost a great deal to a few, but generate little benefit to the many, particularly in cases in which it limits the price of a specific good for the purpose of income redistribution. Rent control and lower-than-world energy prices typify such a situation. The groups paying the costs — in these cases, landlords and oil companies — argue that they are forced to subsidize other groups in the economy. As a result, some withdrew from the market, creating imbalances that governments attempt to correct by initiating new, expensive programs.

Of course, the nature and the dimension of these negative side-effects vary not only among regulated industries but also among the companies operating within these industries. They are as difficult to measure as are the presumed benefits of regulation. Until recently, authorities and the public alike minimized or even dismissed such matters, seeing them as problems that would be sorted out in time. At most, they were considered the price that had to be paid to pursue desirable objectives.

"It is idle to suppose that corporations will not be brought more and more under public control." ALFRED NORTH WHITEHEAD

TODAY'S PERCEPTIONS OF REGULATION

Today, because of the overall economic climate, these negative side-effects are given far greater consideration. In a period of high unemployment and poor productivity, deregulation is seen, rightly or wrongly, as a means of enhancing productivity and economic growth as well as a strategy for achieving price stability.

In addition, deregulation provides governments with an opportunity to be perceived as taking action to promote economic growth without incurring significant expenditures, an important consideration in today's political climate.

A greater awareness of regulation's blemishes and defects has resulted in the organization of lobbies to promote deregulation. These lobbies face a difficult and lengthy task because they are constantly challenged by the vocal few who achieve great benefit from regulation. They must gain broad support from the large number of anonymous consumers who pay a relatively small individual premium for the cost of regulation. Examples of these new lobbyists include consumer groups asking for the removal of dairy or footwear import quotas, large corporations supporting competition in long-distance

"Some form of deregulation is a fact of life, indeed it is inevitable . . . The issue is the degree and the speed with which it occurs." DON MAZANKOWSKI

telephone service, and shippers requesting deregulation in the transportation industry. Their presence has changed the balance of the forces in the political environment.

In addition to such pragmatic considerations, there has also been a significant evolution in the theory of competitive markets. Economists are increasingly accepting the idea that the expected outcome of a highly competitive market — prices fixed at the minimum production costs — can result even if only a few suppliers serve a specific market. This can occur so long as there are no significant barriers to entry and the productive resources involved are mobile. When these conditions are met, existing suppliers always face the threat of newcomers, a possibility that keeps them from abusing their dominant position.

In the current economic environment, it is apparent that General Motors cannot dominate the automobile industry because of competition from Europe and Japan. Other industries such as freight and passenger air transportation are considered to be markets where potential competition serves to discipline market participants as effectively as real competition. This is an important argument for deregulation, because it suggests there is no point in regulating the market — and no public benefit.

In both the U.S. and Canada, the arguments in favour of deregulation have been compelling enough to break down the bureaucratic inertia that so often impedes major changes in public policy. A new perception of government's role in economic management, a more lucid evaluation of what regulation can do and should not do, and pressure from groups who felt injured by regulations have all contributed to the momentum of deregulation.

"Free enterprise is the greatest and most productive system man has ever created. In a modest way, I have been a beneficiary." NELSON ROCKEFELLER

WHERE WE ARE AND WHERE IT ALL MAY LEAD

Clearly, the forces behind deregulation are multi-dimensional and powerful. This process was slow to

FOCUS: FREE TRADE

In 1979, respected author and business consultant Peter Drucker forecast that we were about to embark on a decade of "turbulent times".

He was right.

In the mid-70s, who would have predicted that General Motors and Toyota would undertake a joint venture to produce automobiles in California within 10 years? The idea was contrary to the decades-old cultures of both companies, and a clear violation of long-standing anti-trust regulations.

Who would have guessed that within a decade, the world would be awash in oil, with prices dwindling as OPEC's market share declined?

Who would have guessed that both Canada and the U.S., after electing conservative governments, would see their deficits soar during good times?

These are the sorts of anomalies Drucker told us to expect. They are just a few examples of the mind-wrenching developments that businesspeople have to consider these days in planning their strategies. In the midst of it all, Canada has embarked on a course intended to enhance its role as a trading nation by developing a free-trade arrangement with the United States.

Are we, as a nation, up to the challenge?

Federal Industries' President Jack Fraser recently said:

"The need to achieve is a central feature of the American character. Their society is far more competitive, entrepreneurial, adventuresome and adversarial. Anyone who has done business in the United States knows they play a much harder brand of ball down there. These fundamental differences in the national character of the two countries show up in a number of different ways. In

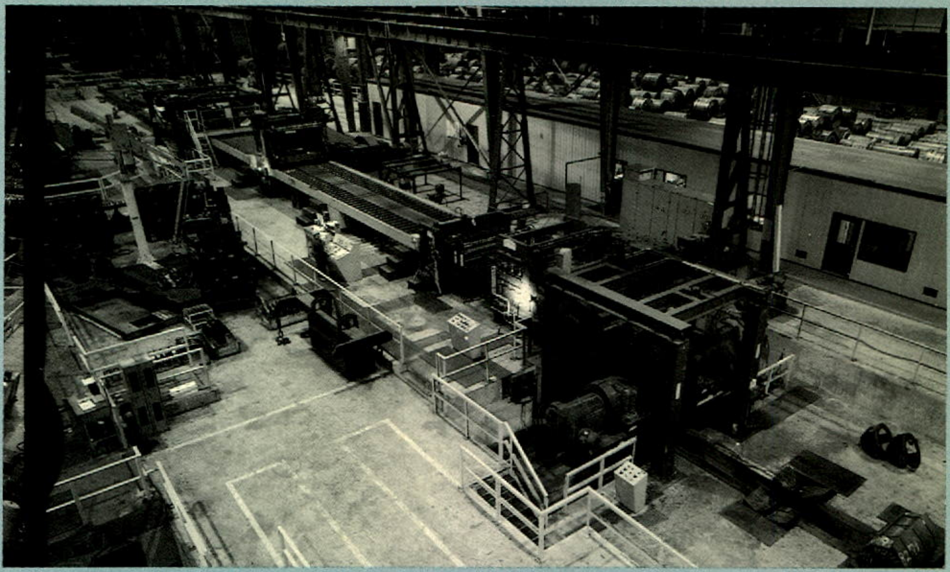
the States, hardy pioneers settled the west before there was any law and order. In Canada, the Mounties went first and the settlers came later. In the States, Lee Iacocca is a national hero and his picture is on the cover of Time. In Canada, our national magazines feature Bob White . . .

. . . it seems to me that entering into free trade arrangements with a country that has a much higher need to achieve brings with it certain very real and unique risks. Can we really be competitive when our economic, historical and social realities are not shaped by a high need to achieve?

. . . Canadian governments since Confederation have been much better at following than leading, and, recognizing political realities, we can't expect a government to take actions that they do not think the majority of Canadians support.

In my view, if we really want Canada to achieve its full potential — and enjoy all the benefits that would flow from such an eventuality — we'd better stop gumming the bullet and give it a good hard bite!"

In the past few years, Canada has enjoyed a strong trade surplus, thanks at least in part to the erosion of the value of our dollar. In 1985, that trading surplus abruptly switched to a deficit, even though our dollar continued to fall in value compared to U.S. currency. Canada has a largely service-based economy, but our "services" balance of trade has been declining for more than a decade. Our large surplus balance has been primarily due to grain exports which have been declining in recent years and may decrease further as the agricultural revolution spreads throughout the world. It is in the export of merchandise that we've been winning of late (up until 1985), and that is an area where countries like Japan and Korea have emerged as major competitive forces.



Russelsteel has maintained good relations with domestic and foreign suppliers despite relatively open flow of steel in and out of Canada. A growing majority of the Company's steel purchases are made in Canada.

John Kettle, one of Canada's leading futurists, says, "Trend is not destiny, as has been said often enough before, but what is going on here is not good news. A rather ominous moment to be starting free trade talks with the Americans."

Will Canada be able to maintain its high standard of living in the changing global economy? That's what Jack Fraser is wondering, and that's the question we must all face as we gear up for the prospect of free trade with the most powerful industrial economy in the world.

One reason to be hopeful is the performance of our steel industry. Steel is the traditional backbone of industrial economies, and the eyes of the world have been focussed upon the debacle that turbulent times have wrought upon the once-proud American steel producers. Mighty U.S. Steel is now more an oil company than a steel company, and some great steel companies of the past are entirely gone.

Canadian steel companies have not escaped from this turbulence unscathed, but by world standards, Canadian steel companies have been outstanding performers. Dofasco, for example, is a model Canadian company in terms of social and community conscience, and has come through recent years with healthy profits and its market share intact.

Our own steel distribution business, Russelsteel, has maintained its strong record of growth and profits almost entirely through its success as a distributor of Canadian-produced steel. Our Canadian borders are relatively open to the import of foreign steel, and Russelsteel has a long history of good supply relationships with foreign producers. Yet in recent years, an increasing preponderance of the steel we buy has come from Canada. In the vast majority of cases, Canadian mills can supply the quality and price that the market requires.

Canada's strong position in steel shows that Canadians *can* compete in free world markets. Motivated Canadian workers *can* be productive, and good Canadian businesses *can* find the capital resources to build world-class facilities. The secret is *management*.

During the relatively good times of the 70s, Canadian companies like Stelco, Dofasco, and Russelsteel ploughed profits back into building the right kind of facilities and management teams to survive and prosper in a more competitive world. Other Canadian industries can do the same.

Canadians *can* make it happen.

emerge in Canada, partly because our governments have been slower to respond and partly because the regulatory framework was able to adapt to changing times, thus weakening the forces driving deregulation.

Nevertheless, many economists believe that the trend to deregulation in Canada will accelerate in the second half of the 1980s.

From the Canadian standpoint, the pressures coming from the U.S. cannot be ignored. In the past decade, the U.S. has initiated extensive deregulation, notably in such

"If everybody minded their own business," the Duchess said in a hoarse growl, "the world would go round a great deal faster than it does." LEWIS CARROLL

areas as transportation, financial services, communications and even pollution control. In certain U.S. industries, Canadians were given access to new markets when the rules of entry were relaxed. This has naturally resulted in demands from U.S. suppliers for reciprocal treatment in Canada.

U.S. deregulation also spilled over into Canada through the extensive economic relationship between the two countries. Canadian transportation companies have had to react to competitive moves from their American counterparts, who reduced their rates in order to attract freight and passengers to their networks. Given the possibility of a North American free-trade zone, the Americans will certainly seek greater freedom to do business in Canada. In many cases, that means deregulation.

"A great deal of the so-called government encroachment on the area of business, labor and the professions has been asked for by the people misusing their freedom." J. IRWIN MILLER

WINNERS AND LOSERS

The possible fate of companies operating in deregulated industries has received little attention thus far. The pro-deregulation lobby usually argues that the possibility of bankruptcy is a necessary element in our economic system and that businesses which were formerly protected by regulation will simply have to adapt if they are to survive against stronger competition.

In the U.S., we have seen that the industrial organization that emerges after deregulation largely reflects the characteristics of the industry itself. In the case of trucking, many new companies entered the truckload market where there are no economies of scale to speak of. The market became more fragmented and competition grew more fierce as new entrants were able to cut prices (largely by paying lower wages to non-unionized labour).

For the less-than-truckload (LTL) market, however, economies of scale do exist. For this reason, in the U.S. LTL trucking is tending toward concentration in the hands of less than a dozen very large carriers. Smaller companies operating in these markets are facing major difficulties because of the more limited range of services they are able to offer. Many have disappeared through mergers, acquisitions or bankruptcies.

Even though concentration indexes show that a greater share of industry income and profits is secured by the largest firms, this does not mean that competition has been reduced at the level of specific markets. In the pre-deregulation era, interstate trucking regulation was strictly enforced in the U.S., and in most corridors there were only a few

FOCUS: CANADIAN TRUCKING DEREGULATION

If Canada is to prosper as a free nation in today's world economy, we must be competitive. As the government's paper *Freedom to Move* notes, many years of well-intended regulatory actions have resulted in excesses that have hampered the nation's competitive position. As thoughtful Canadians, we cannot oppose an honest effort to correct this situation.

That being said, it is also true that Canada is fundamentally a more highly regulated nation than our principal trading partner, the U.S.A.; it also appears that, in general, Canadians support this kind of government. While we do not favour this level of regulation in principle, we accept the fact that operating in a relatively regulated environment is part of being Canadian.

The challenge is to restructure our regulatory environment to enhance the nation's competitive position in a manner that is consistent with Canadian traditions, acceptable to the Canadian people, and causes the least possible upheaval and dislocation.

With regard to the deregulation (or re-regulation) of the Canadian trucking industry — a matter which affects our company directly and one about which we have specific expertise — there is no question that the kind of deregulation that has taken place in the United States would seriously damage our company and our industry. Rapid deregulation would probably bankrupt many smaller companies which are already weak and have not recovered from the last recession. Larger companies such as Motorways Direct might well survive, but profit margins would be eroded.

Perhaps more importantly, there are several giant American trucking companies with substantial financial resources that are well experienced in operating in a deregulated environment. If deregulation happened too quickly in Canada, these companies could establish a dominant position in the Canadian market without great difficulty. As believers in the ethic of free enterprise, we do not oppose their entry into our market. But our government must open the doors prudently, over a reasonable period of time, to give Canadian companies a chance to prepare for a new, more competitive environment.

We support the initiatives laid out in *Freedom to Move*, recognizing fully that their implementation will be painful to our industry. The Canadian trucking industry has significant excess capacity. A more competitive environment will correct that problem over time, but once again, precipitous action could cause permanent damage to the industry.

All these challenges can be managed, resulting in a win/win deal for Canada, for the U.S., for shippers, and for the trucking industry. The transition to a less regulated environment should, however, meet certain conditions:

First ... and most importantly, we need *time*. Establishing a period of several years for the transition will allow needed changes to be made in an orderly manner.

Second ... we need *certainty*. During that transition period, trucking companies and shippers will need to know just what the regulatory environment will be to prepare for the new reality.

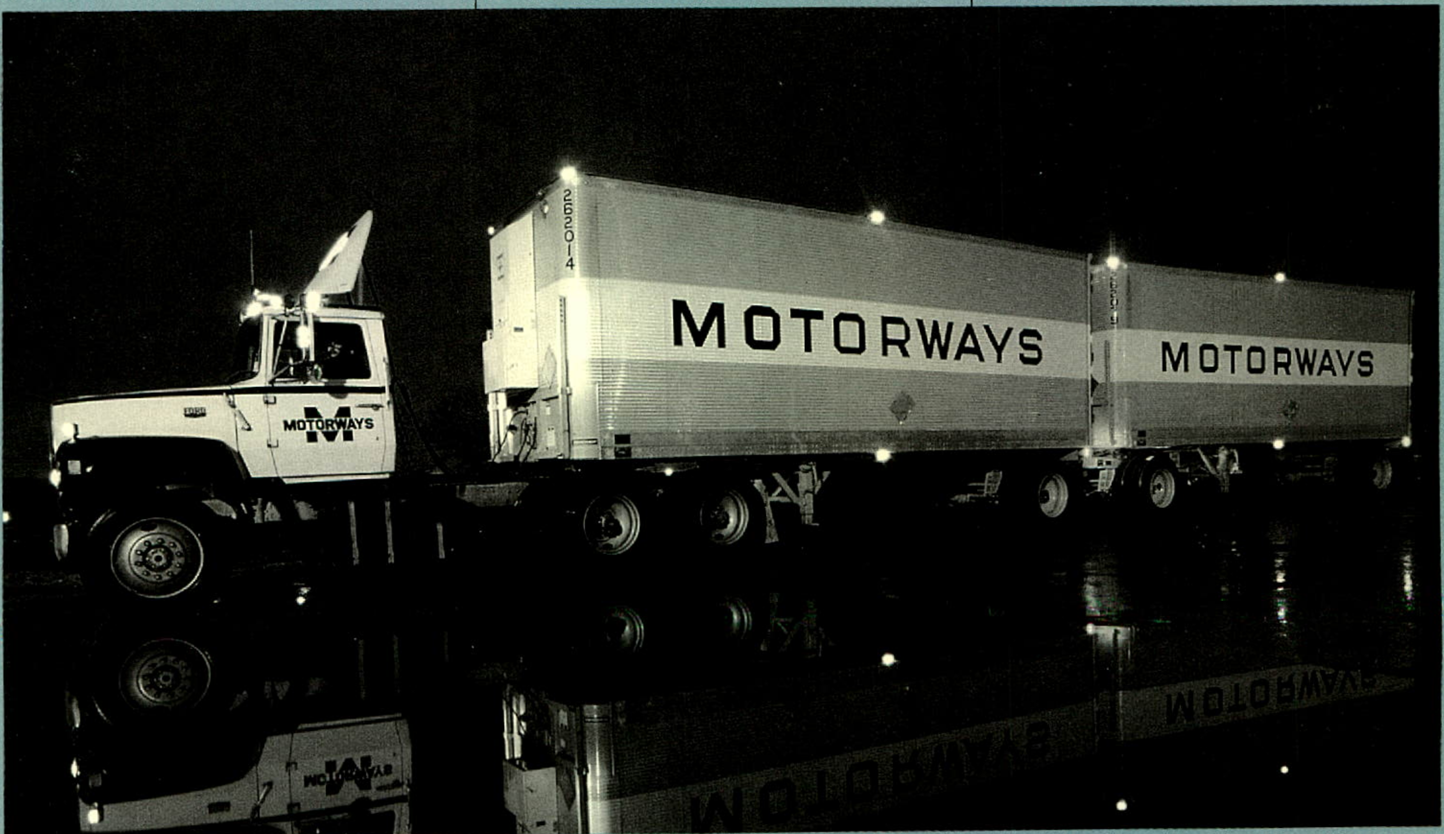
Third ... we need a *well designed regulatory environment* that will truly benefit Canada for the long term ... and one that will not change constantly.

Fourth ... we need corresponding *deregulation of labour laws*. "Common employer rules" mitigate against consolidation by making it impossible for non-union companies to stay non-union after merging with their unionized counterparts.

Fifth ... and finally, we need a *level playing field*. The industry should not be subjected to subsidized competition from Crown corporations, nor from unrestrained U.S. giants that have enjoyed decades of growth in an enormous and competitive market.

We have made very large investments in the trucking industry in recent years, on the assumption that a major change in the regulatory environment was coming. We have structured Motorways Direct to survive and prosper in a more competitive environment. We have challenged our management to improve operating efficiency so that we can compete with the best in the world.

Given time, we are confident they'll be up to the challenge.



Motorways Direct has been structured to survive and prosper in the more competitive deregulated environment laid out in the Canadian government's Freedom to Move *policy.*

authorized carriers.

Today, the majority of shippers can choose from a larger pool of carriers, and thus have more freedom of action in the private-trucking sector. Because LTL is a highly competitive market, large companies differentiate themselves from their competitors by offering specialized services such as just-in-time delivery and by providing a full range of transportation services through inter-modal ownership.

Passenger air transportation is another significant example of the impact of deregulation. In the U.S., the policy of "open skies" first increased competition between established carriers in virtually all markets and led to the entry of many small carriers who flew secondary routes. Business failures and financial reorganization followed. The financially strong and well managed majors were able to overcome the initial shock and are now stronger than ever, while some formerly giant airlines have become pale shadows of their former selves.

The successful airlines retreated from unprofitable markets and consolidated their position by adopting competitive strategies, such as providing bonuses to frequent fliers and achieving control of selected regional hubs. For the most part, regional carriers have allied themselves with national airlines to operate feeder routes integrated into international networks. New airlines have begun operations, several of which have succeeded in becoming profitable while offering low fares. Rate discounts to meet the new competition and for long-haul discretionary clientele have proliferated.

In Canada, deregulation is rapidly changing the face of the passenger air transportation industry. To compete on a more equal footing with Air Canada, CP Air has bought Eastern Provincial and Nordair to fill in the gaps in its network. Quebecair and Pacific Western, the two remaining important carriers — both provincially supported — have decided

"I have never believed in abandoning our economy to the ruthless workings of the marketplace regardless of the human suffering that might be ceased." BERNARD BARUCH

"Private enterprise is ceasing to be free enterprise." FRANKLIN D. ROOSEVELT

Focus: Aviation Deregulation

Several years before deregulation really took off, it was the subject of much scholarly debate among academics and economists. Careful estimates were prepared, projecting the impact and benefits deregulation would bring. In the U.S., deregulation was imposed pretty much as its proponents advocated, presenting an excellent opportunity to see how reality compared with economic theory. One of the experts who was involved in early studies of deregulation is Sam Peltzman. About a year ago, he spoke on the subject of the surprises that emerged during the deregulation process. On the subject of airline deregulation in the U.S., he said:

"On average, prices have fallen relative to what they would have been under continued regulation ... but here is our first surprise: so far, average prices have fallen perhaps only half as much as we had predicted."

He goes on to speculate on various errors that appear to have been made in assumptions and concludes, "*... if, say, five years from now, basic coach fares remain as high ...*" then the economists were wrong.

We don't think they were.

In the year since Dr. Peltzman spoke, air fares have continued to decline in real terms. We don't think the bottom has yet been reached. The reason it's taking longer than the projections indicated is, we think, because of the capital-intensive nature of the business.

In the days of regulation, an airline's fares were largely a function of its costs of operation. Rates were set to allow a reasonable return on the assets a given airline could jus-

Standard Aero Western was created to serve the market for independent commercial airframe maintenance that was effectively created by aviation deregulation in the United States.

tify as necessary to serve its market. In such an environment, airlines became very capital-intensive, not only owning their own expensive aircraft, but also constructing elaborate maintenance facilities, each of which was fully equipped and stocked with parts.

The advent of deregulation reversed the equation. When competition sets the price, profitability is usually enhanced by operating with the minimum assets required to do the job. Upstarts like People Express have won a lot of publicity because of their non-union shareholding work force, but much of their success is also attributable to the fact that they lease their planes and contract for their services. That approach means they can earn a relatively high return on assets while providing service at relatively low margins.

Changing from low-capital intensity to high is easy. It's just a matter of buying equipment and facilities. Changing from high-capital intensity to low is much more difficult and time-consuming. Today's aircraft are mostly owned by the airlines that fly them, and they last a long time. Service facilities are in place and working reasonably well, with most staffed by union workers whose contracts make changes in the status quo extremely difficult. And there are very few well located full-service independent airframe shops around.

Standard Aero Western was created to serve the market that arose from deregulation. Within its first few months of operation, it exceeded the volume anticipated in its startup plan. The company's growth has been limited only by the time and training required to build its staff. There is no other independent facility that is directly comparable, but the few independents that provide similar services are also busy. As more high-quality, well located and cost-effective maintenance facilities become available, airlines like People Express will have increasingly attractive options for their maintenance work.

As new aircraft are required for fleet expansion and replacement, it appears that more and more of them will be leased. Future leases will increasingly be of the "fully serviced" variety, where the lessor protects his investments by contracting for maintenance as part of the lease agreement.

There is good reason to believe that operators like America West, People Express, and Southwest Airlines will be able to maintain or even increase their operating efficiency. Over the years, the majors will have to find new ways to compete or see their market share eroded. It would be surprising if the trend toward reduced air fares that was sparked by deregulation did not continue for several more years.

Be patient, Dr. Peltzman, the invisible hand moves slowly.

to unite their networks, at least partially, by exchanging aircraft in Toronto. Eventually, two or three large, truly national airlines will almost certainly dominate the domestic and international market in Canada. New entrants will be confined to specialized and regional markets. They will likely replace large carriers that have exercised their freedom to abandon routes which have proved unprofitable because of the major carriers' high cost structures.

The advent of greater freedom in doing business does not always produce a happy ending. In Canada, the failures of two banks and of a number of trust companies over the past three years illustrate that stiffer competition goes hand-in-hand with greater risks for market participants as well as for industries as a whole. In the case of financial services, closer surveillance by government and stricter rules of conduct will probably follow what was, until recently, an era of self-regulation within the industry.

Labour has clearly lost in the U.S. deregulation process: the Teamsters Union's membership fell to 210,000 in 1984 from 300,000 in 1979 — a 30% decline. Non-unionized truckers have replaced unionized workers who have been unable to compete because of their higher labour costs. The Teamsters' last national contract provided only a 3.5% pay increase (which was less than the inflation rate), established a two-tier wage system differentiating between veterans and new drivers, and permitted flexible hours to reduce overtime.

Meanwhile, many businesses have rushed to gain dominant positions to isolate themselves as much as possible from competition. Concentration seems to occur very rapidly in industries with high barriers to entry, as has been the case in passenger air transportation as well as in the LTL segment of the trucking industry in the United States. CP Air's recent purchases and Yellow Freight System's history of 65 acquisitions during the period from the late 1950s to the 1970s are but two examples.

CONCLUSIONS

Although deregulation can be an emotional issue because of its implied greater freedom of action — "getting the government off our backs" — its probable impact must be considered objectively to make a realistic assessment of its worth. So far in North America, deregulation has benefited the users in dense markets, but the results are less clear-cut in peripheral markets.

Despite occasional dislocation within specific industries, it is likely that the trend to deregulation will continue. Finance Minister Michael Wilson states that:

"Many industries in this country are over-regulated. Others are over-protected, not just from imports but from domestic competition ... we must reduce the regulatory burden, not as an end to itself, but to release the creative energies of individuals and companies to experiment, to innovate and to produce better goods and services at lower prices."

Freedom to Move, Canada's blueprint for deregulation in the transportation industry, as well as the government's green paper on regulatory reform in the financial system, and the many recent changes in Canadian energy policies, are all evidence of this drive to deregulate. It seems clear that sectors such as communications and agriculture are going to experience fewer stringent regulations in the future. And, if government plans for freer Canada-U.S. trade come to pass, there's little doubt that the political and economic facts driving deregulation will grow even stronger.

FEDERAL INDUSTRIES' POSITION ON REGULATION

There are good regulations and bad regulations, and we don't have a universal position on the matter.

Our Corporate Philosophy says, in part:

"We believe that business conducted in a private enterprise system is the single most significant factor in improving the free world's social and economic conditions."

We recognize that a degree of regulation is necessary, and that enforcing regulations is the right and proper function of government. We believe that the best regulations emerge from a consensus process between government and industry. We believe there is a natural tendency for regulators to over-regulate, because it is in their interest to do so. Everybody wants to be effective and make a contribution, and those who write and enforce regulations naturally have a high opinion of their value.

Periodically, the mechanisms of a free society correct the excesses of government, and that kind of correction is going on right now.

The important thing about regulations is that they are changing. For Federal Industries, change presents opportunities. We watch for those opportunities, and seek ways to convert them into profits. That's what free enterprise is all about.

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