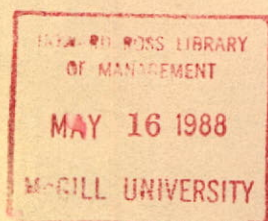


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CANADIAN NORTHSTAR CORPORATION

1987 ANNUAL REPORT



Company Profile

Canadian Northstar Corporation is a diversified investment company headquartered in Calgary, Alberta. The Company is active in merchant banking and investment activities, primarily in the energy sector in Western Canada.

The common shares are listed on The Toronto Stock Exchange and The Alberta Stock Exchange under the trading symbol CNX.

Annual Meeting

The annual meeting of shareholders will be held at the Calgary Petroleum Club, 319 - 5th Avenue S.W., Calgary, Alberta at 10:00 A.M., on Tuesday, May 31, 1988.

Highlights

| | 1987 | 1986 | 1985 |
|--|-----------|----------|----------|
| Financial Results | | | |
| (thousands of dollars) | | | |
| Gross revenue | \$ 35,610 | \$29,320 | \$27,961 |
| Net earnings | 3,674 | 1,068 | 17 |
| Cash flow from operations | 6,175 | 4,574 | 4,255 |
| Total assets | 166,959 | 89,974 | 93,979 |
| Shareholders' equity | 54,336 | 49,533 | 19,193 |
| Per common share (dollars) | | | |
| Net earnings | 0.30 | 0.16 | 0.01 |
| Cash flow from operations (fully diluted) | 1.34 | 1.09 | 1.01 |
| Shares outstanding (millions) | | | |
| Common | 2.33 | 2.32 | 2.32 |
| Junior preferred | 2.70 | 1.88 | 1.01 |

Letter to Shareholders

During 1987, significant progress was made in achieving the Company's objectives. Net income increased to \$3.7 million compared with \$1.1 million in 1986. After providing for dividends on preferred shares, earnings per share increased by 88% to \$0.30, compared with \$0.16 in the prior year. Cash flow from operations increased to \$6.2 million from \$4.6 million.

The Company's strong financial results reflect the steady improvement in the performance of its energy subsidiaries, together with positive results from merchant banking activities, now in the second year of development.

Investment and Merchant Banking

In 1987, a wholly owned subsidiary, Northstar Investment Corporation, was established to pursue financial investment opportunities primarily in Western Canada. This company is well financed and has established an investment portfolio in excess of \$80 million during its first year of operations.

Financial transactions and investments are pursued in companies where the principals have specialized expertise and with operating partners who have proven track records and capital at risk. The company is risk averse in the structuring of its investments, seeking firstly to protect its capital and, secondly, to generate an acceptable annual yield with upside potential for capital appreciation. In this regard, unrealized gains in its investment portfolio now exceed \$5.0 million.

Energy Investments

Northstar Energy Corporation

Canadian Northstar's most significant operating investment is its 65% common share ownership in Northstar Energy. Northstar Energy is a Calgary based company active in both exploration for and production of oil and gas, as well as processing natural gas for other producers. The company's shares are listed on The Toronto Stock Exchange.

Despite soft natural gas prices caused by deregulation, 1987 was a year of continued growth for Northstar Energy. Oil production increased 34% to 573 barrels per day while gas production increased approximately 50% to 5.9 million cubic feet per day and is expected to increase an additional 100% in 1988 as a result of a successful combination of exploration and marketing. Natural gas reserves, net of 1987 production, increased 50% to 77.5 billion cubic feet.

Over the past two years, Northstar Energy has developed a significant new business involving the acquisition and operation of gas processing plants, charging fees to other producers for transporting and processing their hydrocarbons. Gross plant capacity at the end of 1987 exceeded 75 million cubic feet per day.

Northstar Energy's net income for 1987 was \$1.3 million, a substantial increase over 1986, while its cash flow from operations increased 75% to \$5.4 million. In addition, the company was successful in raising approximately \$12.5 million of common share equity, reducing its long-term

debt to less than one year's cash flow.

S & T Drilling Ltd.

The downward cycle for the contract drilling industry continued in 1987 with low rig utilization rates exerting downward pressure on profit margins. However, the Company's 54% owned subsidiary, S & T Drilling, continued to outperform the majority of its competitors by maintaining rig utilization rates in excess of industry averages. Overall, the company generated a nominal loss for the year.

S & T is well positioned for any long lasting turn-around which should occur. The company has increased and upgraded its rig inventory from 9 drilling rigs three years ago to 20 owned or leased rigs in the province of Alberta today.

Financial Activities

During the year, warrants to purchase approximately 820,000 junior preferred shares Series A were exercised by the Company's major shareholders, increasing the capital base by \$4.2 million to \$54.3 million at year end. The conversion right of the junior preferred shares into common shares at a price of \$5.00 per common share expires on June 30, 1988.

A further \$6.0 million was raised from the disposition of other investments and, together with the proceeds from the junior preferred share issue, was reinvested through Northstar Investment Corporation.

Consolidated indebtedness increased approximately \$56 million during 1987, primarily in

connection with the merchant banking activities of Northstar Investment Corporation. However, the increase in debt is well balanced by \$62 million of cash and short-term investments.

Corporate Outlook

Growth in net earnings and share values are expected to continue. The primary growth should come from merchant banking and investment activities, while the Company's existing base should be maintained by its energy subsidiaries.

We will miss the departure of Robert Dunford from our Board of Directors, but are pleased that Ian Cockwell has agreed to stand for election to the Board. The underlying success of the Company is a direct result of the commitment and dedication of our employees throughout our group companies and we are appreciative of the beneficial input and experience of our Board of Directors. We look forward to continued progress in 1988.

On behalf of the Board,



Michael M. Kanovsky
President



John Hagg
Chairman

April 8, 1988.

CANADIAN NORTHSTAR CORPORATION

Consolidated Balance Sheet

December 31, 1987

| | 1987 | 1986 |
|---|------------------|-----------------|
| | (in thousands) | |
| Assets | | |
| Cash and short-term investments | \$ 61,570 | \$17,558 |
| Accounts receivable | 12,951 | 7,054 |
| Investments (note 3) | 23,776 | 11,544 |
| Property and equipment (note 4) | 68,662 | 53,818 |
| | \$166,959 | \$89,974 |
| Liabilities and Shareholders' Equity | | |
| Accounts payable | \$ 11,535 | \$ 7,477 |
| Short-term loans (note 5) | 35,522 | 929 |
| Long-term loans (note 6) | 35,119 | 13,580 |
| Deferred revenue | 3,923 | 4,132 |
| Deferred income taxes | 3,292 | 2,220 |
| Minority interest | 23,232 | 12,103 |
| Shareholders' equity (note 7) | 54,336 | 49,533 |
| | \$166,959 | \$89,974 |

Approved on behalf of the Board



, Director



, Director

Auditors' Report

To the Shareholders
Canadian Northstar Corporation

We have examined the consolidated balance sheet of Canadian Northstar Corporation as at December 31, 1987 and the consolidated statements of earnings, retained earnings and changes in cash 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 as at December 31, 1987 and the results of its operations and changes in cash position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Alberta
April 15, 1988

TOUCHE ROSS & CO.
Chartered Accountants

CANADIAN NORTHSTAR CORPORATION

Consolidated Statement of Earnings

Year Ended December 31, 1987

| | 1987 | 1986 |
|--|--|-----------------|
| | (in thousands except per share amounts) | |
| Income | | |
| Operating | \$28,567 | \$27,238 |
| Investments | 7,043 | 2,082 |
| | 35,610 | 29,320 |
| Expenses | | |
| Operating | 23,049 | 20,887 |
| Interest | 3,998 | 3,671 |
| Depletion and depreciation | 3,035 | 3,143 |
| Income taxes (note 8) | 1,404 | 831 |
| Minority interest | 450 | 346 |
| | 31,936 | 28,878 |
| Net earnings before extraordinary item | 3,674 | 442 |
| Realization of application of income tax loss carry forward | — | 626 |
| Net earnings | \$ 3,674 | \$ 1,068 |
| Net earnings per share after preferred dividends | | |
| — before extraordinary item | \$ 0.30 | \$ (0.11) |
| — after extraordinary item | \$ 0.30 | \$ 0.16 |

Consolidated Statement of Retained Earnings

Year Ended December 31, 1987

| | 1987 | 1986 |
|--------------------------------------|-----------------|----------------|
| | (in thousands) | |
| Retained earnings, beginning of year | \$ 1,468 | \$1,104 |
| Net earnings | 3,674 | 1,068 |
| Preferred share dividends | (2,974) | (704) |
| Retained earnings, end of year | \$ 2,168 | \$1,468 |

CANADIAN NORTHSTAR CORPORATION

Consolidated Statement of Changes in Cash Position

Year Ended December 31, 1987

| | 1987 | 1986 |
|---|----------------|-----------|
| | (in thousands) | |
| Provided by operating activities | | |
| Cash flow from operations (note 9) | \$ 6,175 | \$ 4,574 |
| Provided by (used for) financing activities | | |
| Long-term debt, net of repayments | 21,538 | (23,619) |
| Preferred shares issued | 4,102 | 30,000 |
| Minority interest, net of dividends | 12,166 | (433) |
| Deferred revenue | (443) | (267) |
| Preferred share dividends | (2,974) | (704) |
| Change in non-cash trade accounts | (1,306) | (3,299) |
| | 33,083 | 1,678 |
| Provided by (used for) investing activities | | |
| Investments | (18,347) | 833 |
| Property and equipment | (14,479) | (6,487) |
| Acquisition | (4,381) | — |
| Dispositions — investments | 5,858 | 375 |
| — property and equipment | 1,510 | 14,239 |
| | (29,839) | 8,960 |
| Increase in net cash position | 9,419 | 15,212 |
| Net cash position, beginning of year | 16,629 | 1,417 |
| Net cash position, end of year | \$ 26,048 | \$ 16,629 |

Net cash position consists of cash and short-term investments, net of short-term loans.

Notes to Consolidated Financial Statements

December 31, 1987

1. Significant accounting policies

(a) Principles of consolidation

The consolidated financial statements include the accounts of the Company, its subsidiaries and proportionate interests in various partnerships.

(b) Short-term investments

Short-term investments are carried at the lower of cost and net realizable value.

(c) Investments

Investments are carried at the lower of cost and net realizable value.

(d) Exploration and development costs

The Company follows the full cost method whereby exploration and development costs are capitalized on a country by country basis. Such costs include direct acquisition, exploration and development costs together with applicable overhead and carrying charges, net of government incentives and tax credits. Proceeds from disposals are normally deducted from the full cost pool without recognition of gains or losses.

A ceiling test is employed annually to ensure the costs accumulated by cost centre and for the Company as a whole do not exceed future cash flows from estimated proven reserves and the cost of undeveloped properties. For purposes of this test, future cash flows are determined using year-end prices and costs, including deductions for applicable overhead, financing and income tax expenses.

(e) Depletion and depreciation

Petroleum and natural gas properties, excluding undeveloped properties, are depleted using the unit-of-production method based on estimated proven reserves before deduction of royalties and after conversion to units of common measure based on relative energy content.

Drilling equipment is depreciated to salvage value based on operating days. Replacement of components and pipe repairs are charged to expense as incurred.

Processing facilities are depreciated using the unit-of-throughput method based on estimated total processing volumes over the life of each facility.

(f) Foreign currency translation

The accounts of the foreign subsidiary and other foreign operations are translated into Canadian Dollars on the following basis: monetary assets and liabilities at the year-end exchange rate; other assets and liabilities at historical exchange rates; revenue and expense accounts at average exchange rates prevailing during the year except for depletion and depreciation which are translated at the same rates as related assets. Resulting gains or losses are recognized in the statement of earnings.

(g) **Revenue recognition**

Contract drilling revenue is recognized on either a per day or depth drilled basis according to the nature of individual contracts.

Prepayments for undelivered gas are initially deferred and are recognized as revenue when deliveries are made or on expiry of the period allowed for such deliveries.

(h) **Income taxes**

The Company provides for income taxes based on accounting income regardless of when such income is subject to taxes under the applicable laws. The carrying value of certain investments is in excess of their tax cost base and no provision has been made for potential taxes on this excess which might arise should the Company dispose of these investments.

2. Acquisition

Effective January 1, 1987, the Company acquired a 42% interest in the Gane 1985-86 Production and Development Fund, increasing its consolidated interest in the Partnership to 92%. The aggregate purchase price of \$4,381,000 consisted of cash of \$440,000 and the discharge of promissory notes due from the vendors amounting to \$3,941,000. The acquisition has been accounted for by the purchase method with the purchase price allocated to the net assets acquired as follows:

| | (in thousands) |
|------------------------|----------------|
| Working capital | \$ 531 |
| Property and equipment | 4,140 |
| | 4,671 |
| Deferred revenue | 290 |
| | \$4,381 |

3. Investments

| | 1987 | 1986 |
|----------------------------------|----------------|----------|
| | (in thousands) | |
| Mortgage loan receivable | \$21,069 | \$ — |
| Secured notes | 2,205 | 4,673 |
| Floating rate debenture | — | 3,000 |
| Investment in associated company | — | 2,500 |
| Other | 502 | 1,371 |
| | \$23,776 | \$11,544 |

The secured notes include \$1.45 million (1986 - Nil) of non-interest bearing notes which are due from certain senior officers of a subsidiary company pursuant to the share purchase plan of that company.

4. Property and equipment

| | 1987 | | 1986 | |
|---|----------------|--|-------------------|-------------------|
| | Cost | Accumulated depletion & depreciation | Net book value | Net book value |
| | (in thousands) | | | |
| Petroleum and natural gas properties | \$60,145 | \$10,730 | \$49,415 | \$38,876 |
| Processing facilities | 5,240 | 99 | 5,141 | 1,082 |
| Drilling equipment | 16,620 | 2,514 | 14,106 | 13,860 |
| | \$82,005 | \$13,343 | \$68,662 | \$53,818 |

Undeveloped properties not subject to depletion at December 31, 1987 amounted to \$4.0 million (1986 - \$2.8 million).

Property and equipment with a net book value of approximately \$17 million has a zero cost base for income tax purposes.

Overhead capitalized during 1987 amounted to \$836,000 (1986 - \$671,000).

A gain of \$2,073,000 realized from the sale of certain processing facilities, which were subsequently leased back to the Company, is being amortized over the term of the lease.

5. Short-term loans

Short-term loans of which \$32.4 million are unsecured include operating loans and the current portion of long-term loans. Operating loans bear interest at rates which are based on the bank prime rate.

6. Long-term loans

| | 1987 | 1986 |
|-------------------------------|-----------------|-----------------|
| | (in thousands) | |
| Subordinated note | \$25,000 | \$ — |
| Term loans | 5,981 | 5,343 |
| Subordinated income debenture | 5,000 | 5,000 |
| Bank operating loan | 406 | 3,568 |
| Production loan | — | 598 |
| | <u>36,387</u> | <u>14,509</u> |
| Less current portion | 1,268 | 929 |
| | <u>\$35,119</u> | <u>\$13,580</u> |

The subordinated note is unsecured, bears interest at the bank prime rate and is due on December 31, 1992.

The term loans bear interest at rates based on the prime rate and are secured by certain property and equipment and accounts receivable. Estimated principal repayments are as follows: 1988 - \$1,268,000; 1989 - \$3,700,000; 1990 - \$69,000; 1991 - nil; 1992 - nil; thereafter — \$944,000.

The bank operating loan bears interest at the bank prime rate plus ½% and is secured by certain oil and gas properties and an assignment of accounts receivable.

The subordinated income debenture bears interest at one-half of the bank prime rate plus 1%, payable annually in arrears to the extent of 30% of adjusted net income of a subsidiary, S & T Drilling Ltd. ("S & T"), if earned. The debenture matures in 1989, at which time S & T may require the bank to convert any unpaid portion of the debenture to non-voting common shares of S & T. For the period ended October 31, 1987, interest was not accrued due to insufficient profits and cash flow.

7. Shareholders' equity

| | 1987 | 1986 |
|--|-----------------|-----------------|
| | (in thousands) | |
| Senior Preferred Shares, no stated value authorized - unlimited; issued 1,200,000 cumulative Series A shares having a stated value of \$25.00 | \$30,000 | \$30,000 |
| Junior Preferred Shares, no stated value authorized - unlimited; issued 2,697,570 cumulative Series A shares having a stated value of \$5.00 (1986 - 1,884,460 shares) | 13,488 | 9,422 |
| Common Shares, without nominal or par value authorized - unlimited; issued 2,326,269 shares (1986 - 2,318,669 shares) | 8,680 | 8,643 |
| | 52,168 | 48,065 |
| Retained earnings | 2,168 | 1,468 |
| | \$54,336 | \$49,533 |

- (a) The Senior Preferred Shares, Series A, are redeemable at any time and carry a dividend of 75% of the average bank prime rate.
- (b) The Junior Preferred Shares, Series A, carry a dividend of 75% of the average bank prime rate and are convertible to Common Shares on a one for one basis until June 30, 1988. Holders are entitled to attend and vote at all meetings of common shareholders and under certain conditions will rank equally with common shareholders in the payment of dividends or in the event of dissolution of the Company. During the year, 820,710 shares were issued in connection with the exercise of warrants to purchase such shares and 7,600 shares were converted into Common Shares.

The Junior Preferred Shares, Series A, carry non-detachable warrants enabling the holder to purchase additional Junior Preferred Shares until January 21, 1989. Two warrants are required to purchase one additional Junior Preferred Share at an exercise price of \$5.00 per share; 121,520 Junior Preferred Shares have been reserved for exercise of the remaining warrants which are outstanding.

- (c) At December 31, 1987, 15,000 Common Shares were reserved for stock options to senior officers at an exercise price of \$5.00 per share. The options expire on June 29, 1994.

8. Income taxes

The income tax provision is comprised as follows:

| | 1987 | 1986 |
|----------|----------------|--------------|
| | (in thousands) | |
| Current | \$ (9) | \$671 |
| Deferred | 1,413 | 160 |
| | \$1,404 | \$831 |

Income tax expense varies from the expected provision obtained from applying the effective income tax rate of 49% (1986 - 48%) to earnings before income taxes.

| | 1987 | 1986 |
|---|----------------|-------|
| | (in thousands) | |
| Computed "expected" income taxes | \$2,709 | \$760 |
| Increases (decreases) resulting from: | | |
| Non-deductible Crown payments | 351 | 337 |
| Non-deductible depletion | 353 | 38 |
| Resource allowance | (380) | (278) |
| Non-taxable gain | (1,215) | — |
| Alberta royalty tax credit | (276) | (138) |
| Non-taxable dividends | (946) | (106) |
| Loss carry forward without virtual certainty of recovery | 841 | — |
| Provision for taxes on acquisition | — | 248 |
| Other | (33) | (30) |
| Actual income tax provision | \$1,404 | \$831 |

The Company and its consolidated subsidiaries have unrecognized non-capital and capital losses carried forward of approximately \$3.4 million and \$8.4 million respectively available for offset against future income for tax purposes. The non-capital losses expire at various dates subsequent to 1989.

9. Cash flow from operations

| | 1987 | 1986 |
|--|----------------|---------|
| | (in thousands) | |
| Net earnings before extraordinary item | \$3,674 | \$ 442 |
| Non-cash items | | |
| Depletion and depreciation | 3,035 | 3,143 |
| Deferred income taxes | 1,413 | 160 |
| Minority interest | 450 | 346 |
| Gain on dilution of investment in a subsidiary | (2,556) | — |
| Other | 159 | (143) |
| | 6,175 | 3,948 |
| Realization of application of income tax loss carry forward | — | 626 |
| | \$6,175 | \$4,574 |

10. Segmented information

The Company is active in Canada in oil and gas exploration and production, contract drilling, and merchant banking.

| | 1987 | | | |
|---|----------------|----------------------|----------------------------------|-----------|
| | Oil and gas | Contract drilling | Merchant banking and other | Total |
| | (in thousands) | | | |
| Income | \$12,908 | \$17,004 | \$ 5,698 | \$ 35,610 |
| Earnings (loss) before extraordinary items | \$ 888 | \$ (107) | \$ 2,893 | \$ 3,674 |
| Identifiable assets | \$64,051 | \$20,372 | \$82,536 | \$166,959 |

| | 1986 | | | Total |
|--|----------------|-------------------|----------------------------|----------|
| | Oil and gas | Contract drilling | Merchant banking and other | |
| | (in thousands) | | | |
| Income | \$11,799 | \$17,521 | \$ — | \$29,320 |
| Earnings (loss) before extraordinary items | \$ 134 | \$ 308 | \$ — | \$ 442 |
| Identifiable assets | \$55,976 | \$16,798 | \$17,200 | \$89,974 |

11. Lease commitment

The Company has a lease obligation covering certain gas plant equipment estimated at \$1,749,000 annually for the period from 1988 to 1997.

12. Related party transactions

The Company has entered into transactions with affiliated companies and certain senior officers, the terms and conditions of which are in the normal course of business except as disclosed in note 3.

13. Comparative figures

Certain 1986 comparative figures have been reclassified to conform with the current year's presentation.

Corporate Information

Head Office

1130 Sunlife Plaza
140 - 4th Avenue S.W.
Calgary, Alberta T2P 3N3
Telephone (403) 261-4830

Principal Subsidiaries

Northstar Energy Corporation
1130 Sunlife Plaza
140 - 4th Avenue S.W.
Calgary, Alberta T2P 3N3
Telephone (403) 261-4830

Northstar Investment Corporation
1130 Sunlife Plaza
140 - 4th Avenue S.W.
Calgary, Alberta T2P 3N3

S & T Drilling Ltd.
2000 Sunlife Plaza
140 - 4th Avenue S.W.
Calgary, Alberta T2P 3N3
Telephone (403) 234-7361

Auditors

Touche Ross
Calgary, Alberta

Registrar and Transfer Agent

The Canada Trust Company
505 - 3rd Street S.W.
Calgary, Alberta T2P 3E6

Stock Exchange Listings

The Toronto Stock Exchange — CNX
The Alberta Stock Exchange — CNX

Officers

John A. Hagg
Chairman

Michael M. Kanovsky
President

Brian K. Lemke
Treasurer and Corporate Secretary

Directors

John W. Burrows, Calgary (1)
Chairman of the Board,
Novatel Communications Ltd.

Ian G. Cockwell
Chairman of the Board,
Westcliffe Management Services Inc.

Robert A. Dunford, Toronto (2)
Executive Vice President,
Administration
Brascan Limited

John A. Hagg, Calgary
Chairman of the Company

Michael M. Kanovsky, Calgary (1)
President of the Company

David W. Kerr, Toronto (1)
President,
Noranda Inc.

(1) Member of the Audit Committee

(2) Not standing for reelection

