Gardiner Watson Limited

Institutional Services

DALCO PETROLEUM LTD. ($0.90)

BILL PROCTER
DRUMMOND LIPPENS

MARCH, 1982

Members:
Toronto Stock Exchange
Alberta Stock Exchange
Vancouver Stock Exchange
Investment Dealers Association
of Canada

Head Office:
11 Adelaide Street West
Toronto, Ontario M5H 2R4
Institutional Sales & Research
(416) 868-1610
Montreal (514) 871-1890
Retail Sales (416) 862-8142

Calgary, Alberta
(403) 262-7061

Ottawa, Ontario
(613) 236-1333

Vancouver, B.C.
(604) 687-6776

TABLE OF CONTENTS

DALCO PETROLEUM LTD.**

Current Price	1981-1982 Price Range	Cash Flow Per Share: Year Ending May 31: 1981A	1982E	Year Ending Dec. 31: 1982	1983
$0.90	$6 3/4-0.85	$0.29	$(0.10)	$0.00	$0.25

After-Tax Asset Value Per Share Discount Rate: 15%	20%	Market to Asset Value Ratio: 15% DCF	20%DCF	Shares o/s	Float
$5.11	$3.43	18%	26%	14.8 MM	5.1 MM

RECOMMENDATION

We recommend the purchase of Dalco common shares for significant capital appreciation potential over the next one to two years.

SUMMARY

1. Dalco's financial quality and cash flow picture have deteriorated drastically during the past eighteen months. Long-term debt currently exceeds $60 million, or $4 per share, the debt:equity ratio has mushroomed to 5.0:1 and cash flow in the past two quarters has been negative. These problems have not been ignored by investors for the shares have plummeted from over $6 to the current price of $0.90.

   We think we have seen the worst. Aggressive action by management to rationalize the asset base, thereby reducing the debt and interest expense burden, coupled with large gas price increases should place the Company in a positive cash flow position by late 1982. Cash flow could reach the $0.25 per share range in calendar 1983.

2. The key to Dalco's asset value is still its shallow gas reserves in the Medicine Hat region of southeastern Alberta. Primarily as a result of the favourable pricing schedule for gas agreed to under the N.E.P., the pre-tax value of the Company's Canadian reserves actually increased by over 50% during the past eighteen months. Therefore, we calculated Dalco's pre-tax asset value to be $10.60 per share discounting at 15%, $7.12 per share using a 20% rate and $5.10 using 25%.

3. Since the asset value and the stock price were apparently moving in opposite directions, we employed a second engineering consulting firm to evaluate Dalco's largest gas property, Channel Lake South, and most important oil property, Nipisi. The two appraisals differed by less than 5% on Channel Lake South and by about 20% on Nipisi. Applying these reductions to all of Dalco's Canadian properties, and reducing the numbers further by capitalized overhead expenses and a 20% tax rate, we arrived at after tax asset values of $5.11 per share discounting at 15% and $3.43 using a 20% rate. (Most analysts use a 40% tax rate but exclude general and administrative expenses. In Dalco's case, deducting capitalized overhead expenses has the almost identical effect of increasing the tax rate from 20% to 40%).

** A new corporate name, DYNEX PETROLEUM LTD., has been reserved and, in all likelihood, will be in use in the next month or two.

4. Dalco's expansion into the United States has been disappointing to date. The current annual cashflow shortfall is a very meaningful $0.42 per share (shortfall between oil and gas profits and interest on the associated debt). However, using a 20% discount factor, independent consultants valued the properties at $38.9 million pre-tax. If we slashed the value to $20.9 million, which we are confident the Company could fetch even in a distress sale, Dalco's asset values would still be almost $4 per share fully taxed using a 15% discount rate and $2.60 using 20%. Even under our most pessimistic scenario, Dalco is trading at only 35% of asset value.

5. The Company has two U.S. properties; East Texas, and Brazoria County, Texas which could significantly augment the asset value. Further activity is planned on both properties this year.

6. Finally, the proposed merger between Lonnie Dunn International and Dalco's U.S. parent, Dalco Petroleum Corporation, should provide the Company with "door openers" to excellent oil and gas as well as financial people. These new associations could play a key role in the Company's future growth through farmout or joint venture agreements on both existing and new properties.

In conclusion, investors should gain some measure of comfort from a hard asset value of almost $3 per share or three times the current stock price. Cash flow is currently negative but should return to a positive position by late 1982. The magnitude of the improvement in 1983-84 cash flow will be primarily a function of gas demand in Canada, lower interest rates and management's ability to rationalize the existing asset base.

DALCO PETROLEUM LIMITED

BACKGROUND

Dalco, a medium size oil and gas producer based in Calgary, originally emphasized the development and production of shallow, tight gas sands in southeastern Alberta. Today, Dalco has approximately 300 gas wells on production in the Medicine Hat region which provide the bulk of the Company's cash flow and asset value. During the 1979-81 period, Dalco expanded its exploration efforts to include all of Alberta, British Columbia, the western United States and Texas. In addition to oil and gas development, Dalco owns a contract drilling division, Dolphin Drilling, which operates four rigs in Alberta and a liquid petroleum gas marketing division.

Dalco Petroleum Corporation, a U.S. public company, currently owns 65.7% of the 14.8 million shares outstanding and controls 49.9% of the voting shares.

GARDINER WATSON'S INVOLVEMENT

In early 1981, Gardiner Watson acted as agent in the sale of 1.2 million common shares of Dalco from the U.S. parent to Canadian investors. We published a report at the time which included a description of the Company's operations, asset value calculations and cash flow estimates. At $6.00, the shares were at a 23% discount to our Canadian asset value estimate of $7.76 (pre-tax, 15% discount rate). The U.S. assets, which were still in the early exploration phase but appeared to offer excellent potential, were valued at cost. (Since the U.S. activities were financed by debt, the $10 million cost value was offset with associated debt, leaving the net value for the Company at $7.76 per share). Cash flow was expected to increase from $0.49 per share in fiscal 1980 to over $1.00 per share by fiscal 1982.

During the past year, the shares have collapsed to under $1.00 per share. Cash flow is currently negative. Long-term debt has jumped nearly four-fold to $60 million during the past eighteen months. Many investors are questioning the asset values being placed on the Company's reserves and in fact, the ability of Dalco to survive.

We obviously regret having recommended the shares last year at $6.00. We can not change history but we will attempt in this report to shed some light on the problems of the past twelve months and to provide investors with a fair and objective evaluation of the Company's asset value and current cash flow prospects.

WHAT WENT WRONG?

First, production was reduced due to the initial disagreement between the Federal Government and Alberta. Dalco was disproportionately affected by the Alberta Government's decision to reduce the production rate on all Crown leases since the Company's major oil producing property, the Nipisi field, had a much higher than average daily flow rate. Second, the "voluntary" cutback by TransCanada PipeLines significantly reduced gas sales. Third, the N.E.P. agreement not only delayed the expected gas price increase and imposed a more onerous P.G.R.T. (an effective 12% tax on gross operating profits rather than the more customary net profit number) but also contributed to a major slowdown in Canadian oil and gas activity by sharply reducing producer netbacks and lowering the asset value of many companies. Profits in Dalco's drilling division and LPG marketing subsidiary suffered as a result.

The new rules introduced by the Federal Government were only part of the problem. Dalco's major diversification program into the United States experienced many disappointments. Some wells proved to be dry, others that did have good initial flow rates declined sharply shortly after entering production and still others were delayed in reaching production by gas contract problems. Since all the U.S. plays were financed by loans at prime related rates, and real interest rates remained at an exceptionally high level, the shortfall in cash flow had to be absorbed by the Canadian operations. Under normal circumstances, even this would have been possible but coupled with the production cutbacks in Alberta, cash flow did fall below the breakeven level ($-1.1 million or $0.07 per share) in the latest six-month period ending November 30, 1981.

The negative implications of the N.E.P., attractive bond and short-term paper yields, and more recently a reduction in world oil prices have combined to place great downward pressure on all oil and gas stocks. The T.S.E. Oil and Gas Index which is heavily weighted by the integrated and presumably more stable companies, has fallen by over 50% from its peak last year. Many of the larger producers such as Dome Petroleum are down by 60% to 70%. Therefore, it is not surprising to find several junior companies, Dalco included, that have declined by 80% or more from their 1981 peak levels. A full list of over 100 companies is presented in Appendix A.

CURRENT ASSET EVALUATION

1. Oil and Gas in Canada

The key to Dalco's asset value is still its shallow gas reserves in southeastern Alberta. Three properties, Channel Lake, Channel Lake South and Drowning Ford, account for 71.7 billion cubic feet of proven gas reserves or over 80% of the Company's net total. Only 1% of Dalco's total Canadian gas reserves are classified as probable; 99% are proven and over 80% of the proven reserves are developed. Although the Medicine Hat wells produce at a relatively low average of 115 MCFD from the Milk River, Medicine Hat and Second White Specks zones, the low productivity ensures a more modest Provincial royalty rate and hence, a very acceptable after-tax netback. Also, given an annual decline rate of about 6% and favourable gas pricing, most if not all these wells should still be in production thirty years from now.

Oil is not nearly as important to Dalco (the Company has an interest in 50 producing oil wells compared to 302 producing gas wells and 54 shut-in gas wells) but still accounts for approximately 11% of the Canadian oil and gas asset base. The two principal oil properties, Nipisi and Cherhill, both located northwest of Edmonton, would account for nearly 90% of the Company's total Canadian oil reserves of 840,000 barrels proven and 1.27 million proven plus probable.

Dalco's reserves are evaluated every six months by an independent petroleum engineering company. Primarily as a result of the favourable pricing schedule for gas agreed to under the N.E.P., the Company's pre-tax asset value discounted at 15% has actually increased dramatically during the past eighteen months, as shown on the following page.

TABLE I

DALCO: CANADIAN OIL AND GAS ASSET EVALUATION

($ Millions)

	May 31/80	May 31/81	Nov. 30/81	Increase Over 18 Months	
Gas - Proven	$ 91.7	$ 94.7	$136.4	$44.7	48.7%
- Probable Additional	1.2	2.3	1.5	0.3	25.0
Total Gas	92.9	97.0	137.9	45.0	48.4
Oil - Proven	10.3	12.8	17.4	7.1	68.9
- Probable Additional	4.1	5.9	6.9	2.8	68.3
Total Oil	14.4	18.7	24.3	9.9	68.8
Grand Total	$107.3	$115.7	$162.2	$54.9	51.1%
Asset Value Per Share*	$ 7.29	$ 7.45	$10.40	$3.11	42.6%

* After deducting long-term debt, adjusting for working capital and other assets and valuing the U.S. assets at cost.

We had no reason to doubt the values presented by the independent engineering company for we know the firm to be very well respected in the Calgary oil and gas community; but because the apparent asset values had increased from $7.29 per share to over $10 while the stock price declined from the $4.00 to $6.00 per share range to only $1.00, we elected to have a second opinion. With the permission of and assistance from Dalco management, we contracted another independent engineering group to appraise the Company's most important gas property, Channel Lake South and largest oil property, Nipisi.

The estimated gas reserves in Channel Lake South, the production profile and gas pricing forecasts were very similar in both studies. The major difference was the Small Explorers' Tax Credit which was included in the pre-tax values calculated by Dalco's consultant. Adjusting for this tax credit, the two appraisals differed by less than 5%.

The spread in estimated values for the Nipisi property was far greater. Dalco's consultant presented two values, one for proven reserves only and one for proven plus probable. The single value calculated by Gardiner Watson's consultant fell between the two but was closer to the proven only value.

Both consultants used the pricing schedule for conventional old oil recently agreed to by the Federal and Provincial governments. However, since there is some question whether these prices will be reached given the current surplus of world oil and an apparent slowdown in inflationary rates, we also asked our consultant to present a value for Nipisi based on a constant landed oil price in Montreal for the period 1982-84 and escalating at nine percent per year thereafter. The estimated value was reduced by about 13% on a pre-tax basis.

TABLE II

DALCO: COMPARATIVE EVALUATIONS OF CHANNEL LAKE AND NIPISI
(Pre-Tax $ Millions)

	Including The Small Explorers' Tax Credit	
	DISCOUNT RATE	
	15%	20%
CHANNEL LAKE		
Dalco's Consultant	$53.2	$36.7
G.W.'s Consultant	51.2	35.2
Per Cent Difference	-3.8%	-4.1%
NIPISI		
Dalco's Consultant		
(1) Proven	$11.7	$ 8.9
(2) Proven plus Probable	15.2	11.4
G.W.'s Consultant		
(3) Old Oil Price Schedule	$12.7	$ 9.7
(4) Conservative Oil Pricing Schedule	10.2	8.1
Per Cent Difference		
(1 vs 4)	-12.8%	-9.0%
(2 vs 4)	-32.9	-28.9
(1 vs 3)	+8.5	+9.0
(2 vs 3)	-16.4	-14.9

We have no reason to suggest that one consultant's values are more realistic than another. Fortunately, most of Dalco's Canadian asset base consists of proven gas reserves similar to the Channel Lake South property where the two evaluations were extremely close. Since Dalco's consultant has slightly higher values, we have used the Company's numbers in our "more optimistic" case. A more conservative evaluation was also prepared by deducting 4.0% from the Company's gas reserve value and 20% from the value of the proven plus probable oil reserves.

In additon to those projects where revenue predictions were prepared, Dalco's consultant assigned a value of $3.0 million to non-producing lands based on recent land sales and exploration activity. The Company also has undeveloped land in Canada which we valued at cost ($3.7 million).

2. U.S. Oil and Gas Assets

Based on readily available markets for oil and gas production and attractive "netback" prices, Dalco made a major commitment in 1979 to expanding into the United States. Properties were acquired in Texas, Oklahoma, Wyoming, New Mexico and Montana. To date, the Company has participated in 76 wells which resulted in 34 oil wells, 19 gas wells and 23 dry holes. The capital invested as of November 30, 1981 totalled $35.4 million. In addition, the Company has spent $5.1 million to build a gas processing plant in Oklahoma which has yet to show a profit and is in the process of being sold.

Even though Dalco placed great emphasis on short payout programs and the drilling success ratio of 70% is very acceptable, there has been a serious shortfall between interest expense on the associated debt and cash flow from operations. Based on the six month period ending November 30, 1981, the current annual shortfall is a very meaningful $0.42 per share.

TABLE III

DALCO: U.S. INVESTMENTS AND CASH FLOW

($ Millions)

	Fiscal 1980	Fiscal 1981	1st H F'82
Capital Invested	$10.0	$25.6	$ 4.9
Cumulative Investment	10.0	35.6	40.6
Gross Profit	$ 0.0	$ 1.4	$ 0.9
Interest Expense (E)	0.8	3.9	4.0
Cash Flow Shortfall	$ 0.8	$ 2.5	$ 3.1
Shortfall Per Share	0.05	0.17	0.21

The asset value picture is considerably more attractive. The independent consultants employed by Dalco have placed a pre-tax value of $40.5 million on the U.S. properties (discounted at 15%), or 14% higher than the Company's cost. Employing a more conservative 25% discount rate, the estimated value declines to $32.0 million which is 90% of cost. Unproven leases in each case were included at cost ($6.5 million). In addition, we assigned a value of $3.3 to $3.9 million to the Cashion gas plant in Oklahoma.

TABLE IV

DALCO: U.S. OIL AND GAS EVALUATIONS

($ Millions: Nov. 30, 1981)

	PRE-TAX DISCOUNT RATE			AFTER-TAX DISCOUNT RATE		DISTRESS SALE VALUE
	15%	20%	25%	15%	20%	
East Texas, Texas	$17.7	$14.8	$12.9	$14.1	$11.8	$ 7.4
Dewey County, Okla.	9.6	7.9	6.9	7.7	6.3	3.9
Other Okla. and Austin Chalk, Texas	5.3	4.7	4.4	4.2	3.8	2.4
Wyoming and New Mexico	1.5	1.3	1.2	1.2	1.1	0.7
Unproven Leases at Cost	6.5	6.5	6.5	6.5	6.5	3.3
Cashion Gas Plant	3.9	3.7	3.3	3.9	3.7	3.3
TOTAL	$44.5	$38.9	$35.2	$37.6	$33.2	$ 21.0
Capital Invested	$40.6	$40.6	$40.6	$40.6	$40.6	$ 40.6
Unrealized Profit or Loss	$ 3.9	$(1.7)	$(5.4)	$(3.0)	$(7.4)	$(19.6)

Dalco's key U.S. play is East Texas where the Company has working interest which vary from 50% to 95% in 11,000 acres. Eight gas wells have been drilled to the Cotton Valley horizon at 11,000 feet and production casing run. Being classified as "tight", the gas receives a very attractive price of U.S. $5.25 per MCF or double the base price but the high price has tended to delay hook-ups to pipelines. Also, the flow rates from the wells that are on production have been somewhat disappointing.

The engineering report suggests that based on the experience of offset wells in the area, a production history of at least nine months is necessary before accurate forecasts can be made. Therefore, as of November 30, 1981, only 18% of the total reserves in East Texas were classified as proven; $14.5 million or 82% were still in the probable category. Another concern is the gas price forecast. In a period of slower economic activity and unstable world prices, "tight" gas at 200% of the base price is vulnerable in a deregulated environment.

To arrive at a most conservative value for the U.S. oil and gas properties, we arbitrarily cut the estimated pre-tax values using a 20% discount factor in half, reducing the number to $17.6 million. We are confident that Dalco could liquidate its U.S. portfolio of properties for this amount even in the current environment of tight money and widespread pessimism.

3. Contract Drilling Operations

Dalco's drilling fleet, which operates under the name of Dolphin Drilling, consists of four rigs. Rig No. 1, with a capacity to drill up to 3,000 feet, commenced operations in 1975, No. 2 (3,000 foot maximum) and No. 3 (6,000 feet) started in 1978 while No. 4 (6,500 feet) was added in August, 1980. Even though 90% of the division's revenues come from thirdparty sources, the group's excellent reputation for reliability and service has enabled the Dolphin rigs to maintain an activity ratio 50% higher than the industry average. Therefore, in spite of the slowdown in drilling activity resulting from the N.E.P. and high interest rates, Dolphin should be able to maintain a gross profit contribution of $1.5 to $2.0 million.

TABLE V

DOLPHIN DRILLING: GROSS PROFIT CONTRIBUTION

($000's)

	1ST HALF F'82	1ST HALF F'81	1981	1980	1979	1978
No. of Rigs	4	4	4	3	3	1
Revenues	$4,045	$4,285	$7,678	$6,024	$3,278	$1,155
Expenses	2,899	2,991	5,915	4,273	2,112	731
Gross Profit Contribution	$1,146	$1,294	$1,763	$1,751	$1,166	$ 424

We believe a conservative market value for Dolphin would be $4.0 million. The four rigs had a book value of $4.0 million at the end of fiscal 1981 and the division clearly has excellent "good will" in the industry. Also, if the gross profits (before depreciation and head office overheads) were taxed at 45%, the multiple on the after-tax profits of $960,000 would be a very conservative 4.2.

4. Gas Liquids Marketing

Dalco was formed in 1973 as a marketer of gas liquids in Canada, an extension of the parent's primary business in the U.S. The division purchases propane and butane for re-sale and shipment, via leased tank cars, to wholesale and retail distributors throughout North America. The major asset of the division is its management and sales force for it is truly a people business which generates a relatively large revenue (marketing accounts for approximately half of Dalco's total revenue) but invariably at a razor-thin margin.

As shown in Table VI on the following page, profits are also very volatile, reaching a peak of nearly $2 million in fiscal 1980 as propane sales were boosted by an extremely cold winter and a very good crop drying season. Profits were cut in half last year as milder weather and a reduction in retail gasoline consumption lead to an industry surplus. Weak markets and lower margins were also the order of the day throughout the first half of fiscal 1982 but the division continued to make a positive contribution to profits.

Since gross profits have averaged over $750,000 during the past five years, we believe LPG trading is worth at least $1 million (three times average after-tax profits) to Dalco in an asset value calculation. The division is relatively insignificant in terms of the Company's total asset base ($0.07 per share) but can be an important contributor to cash flow, particularly in a strong year. For example, since all of Dalco's taxes were deferred, the contribution to cash flow (before head office allocations) in 1980 reached $0.13 per share.

TABLE VI

LPG MARKETING: GROSS PROFIT CONTRIBUTION

($000's)

	1ST HALF F' 82	1ST HALF F' 81	1981	1980	1979	1978
Revenue	$10,184	$7,002	$16,590	$13,628	$4,003	$4,183
Expenses	9,903	6,578	15,654	11,711	3,450	4,153
Gross Profit	$ 281	$ 424	$ 936	$ 1,917	$ 553	$ 30
Profit Margin	2.8%	6.1%	5.6%	14.1%	13.8%	0.7%

5. Other Assets

The largest item in the other asset category is working capital which as of November 30, 1981, amounted to $5.6 million or $0.38 per share. Working capital has actually increased during the past eighteen months from less than $1 million primarily due to a jump in accounts receivable. To be conservative, we discounted accounts receivable by $1.0 million to arrive at a working capital value of $4.6 million or $0.31 per share.

Dalco has other assets and prepaid taxes of $4.0 million as of November 30, 1981 which we believe could be inflated by as much as $2.0 million. The major item is an advance the Company made to an employee share purchase plan. Funds in the plan were used to purchase shares of Dalco at an average price of $4.73 per share. It is questionable whether the liability or difference between the purchase price of $2.5 million and the current market value of $0.5 million should be written off but to be conservative, we have valued Dalco's other assets and prepaid taxes at only $2.0 million.

6. Liabilities

Dalco has liberally employed debt financing to execute its diversification program into the United States. To date, the Company has invested $40.6 million in the U.S. and long-term debt has increased by $44 million during the same period of time. As of November 30, 1981, long-term debt amounted to $60.4 million or $4.09 per share compared to shareholders' equity of only $12.2 million or $0.82 per share. Since virtually all of the debt is at prime plus rates and, unlike many of the Canadian oil and gas companies, Dalco is expensing all interest charges, the debt burden has been a serious limiting factor on the Company's ability to generate a positive cash flow during the past year. Annualized interest expenses are currently $12.7 million or a staggering $0.86 per share.

Also, since Dalco is paying no taxes, the after-tax cost of financing is a prohibitive 18%. The interest rate has no relevance in an asset value calculation for only the absolute dollar amount of the liability is deducted but does become crucial in an estimate of cash flow.

TABLE VII

DALCO: LONG-TERM DEBT AND INTEREST TRENDS

($ Millions)

	Nov. 30 1981	May 31 1981	May 31 1980	May 31 1979
Long-term Debt	$60.4	$51.4	$16.7	$12.4
Shareholders' Equity	$12.2	$14.8	$13.8	$ 1.4
Debt:Equity Ratio	5.0:1	3.5:1	1.2:1	9.1:1

	6 Mo. Ended Nov. 30 1981	Fiscal Year Ended May 31 1981	Fiscal Year Ended May 31 1980	Fiscal Year Ended May 31 1979
Interest Expense	$12.5*	$ 5.9	$ 2.4	$ 1.4
Interest Coverage Ratio	0.8X	1.8X	3.9X	3.3X
Effective Interest Cost (E)	21%	17%	16%	13%

* First half annualized

In addition to the long-term debt liability, one must deduct deferred revenue of $4.3 million and deferred income taxes of $3.6 million (equal in total to $7.9 million or $0.53 per share) before arriving at a fair asset value.

7. General and Administrative Expenses

There is some question as to whether general and administrative expenses should be capitalized at an appropriate rate and deducted in an asset value calculation. One could argue that each individual property could be sold to another producing oil and gas company (based on direct costs only) since the buyer has the necessary overhead staff already in place. Second, management would argue that a portion of the head office expenses (for example, the salaries and related expenses of the geological team) relate to the development of new properties and that these properties will reflect the higher value over time (i.e. similar to a real estate company spending money to service raw land). Also, it is common practice in the industry not to capitalize administration expenses in an asset value presentation.

On the other hand, Dalco is not likely to liquidate its portfolio of properties. The general and administrative expenses must be deducted before the cash flow from the properties can be reinvested or paid out to shareholders. We have presented both cases.

The Company's general and administrative expenses are currently about $3 million, of which we assumed two-thirds or $2 million would be required to operate the Company if little or no new exploration was undertaken. Assuming this expense item increases by 10% per year, the present value discounting at 15% and 20% is $33.5 million ($2.27 per share) and $19.5 million ($1.32 per share) respectively.

8. Taxes

Like most oil and gas companies, Dalco presents in their annual and semi-annual reports the present value of reserves on a pre-tax basis only. Dalco has not actually paid any income taxes in the last few years nor does it appear likely that the Company will reach a taxable position in the near future. Currently, all of the oil and gas revenue is being "sheltered" by interest and overhead expenses but even if pre-tax earnings were positive, Dalco does have capital expenditure pools that will reduce income taxes payable. Once again, Dalco's pre-tax asset values are perhaps realistic but also the "more optimistic" case. In our "more conservative" case, we applied a tax rate of 20% (Note: a normal tax rate is closer to 40% but we assumed approximately half of the gross income will be sheltered by interest and overhead expenses).

9. Discount Rates

Last year, a discount rate of 15% was widely accepted in the oil and gas industry as well as the investment community. In retrospect, given that long-term government bonds were yielding 15%, a 15% discount factor in a less than certain industry was clearly too low. A more appropriate rate then and now would be 20%.

10. Asset Value Per Share

The range of asset values presented in Table VIII on the following page is very wide (from a high of $10.60 per share to a low of $2.60) but all are a multiple of the current stock price.

Using the same values prepared by Dalco's consultants, we generated a net asset value of $10.60 per share with a 15% discount rate, $7.12 per share with 20% and $5.10 with a 25% rate.

Using the somewhat more conservative reserve values prepared by Gardiner Watson's consultant on the Canadian properties, a reduction for taxes of 20% and a reduction for capitalized general and administrative expenses, we arrived at a net asset value of $5.11 per share with a 15% discount rate and $3.43 per share with 20%. These numbers were further reduced to $3.98 and $2.60 per share by assuming a minimum distress sale value for the U.S. properties of $17.6 million.

Most analysts do not capitalize overhead expenses in generating asset values but employ a tax rate of 40% rather than the 20% we used. In Dalco's case, it just so happens that we would arrive at almost identical per share numbers by increasing the tax rate from 20% to 40% and excluding capitalized administrative expenses.

TABLE VIII

DALCO: ASSET VALUE CALCULATIONS
($ 000's)

	"OPTIMISTIC CASES" Dalco's Consultants: No Income Taxes or Overhead Expenses Deducted			"MORE CONSERVATIVE CASES" Gardiner Watson's Consultant Income Taxes of 20% and Overhead Expenses Deducted		"MOST PESSIMISTIC CASES" G.W.'s Numbers on Canada Income Taxes and Overhead Expenses Deducted Distress Sale of U.S. Assets	
	DISCOUNT RATE			DISCOUNT RATE		DISCOUNT RATE	
ASSETS	15%	20%	25%	15%	20%	15%	20%
CANADIAN OIL AND GAS PROPERTIES							
: Proven Reserves	$153,826	$110,075	$ 85,217	$115,904	$ 83,040	$115,904	$ 83,040
: Probable Reserves	8,397	6,179	4,822	5,406	3,889	5,406	3,889
: Non-Producing Land	3,043	3,043	3,043	3,043	3,043	3,043	3,043
: Undeveloped Land	3,739	3,739	3,739	3,739	3,739	3,739	3,739
TOTAL CANADIAN	169,005	123,036	96,821	128,092	93,711	128,092	93,711
U.S. OIL AND GAS PROPERTIES							
: Proven Reserves	11,560	10.930	9,555	9,248	8,744		
: Probable Reserves	22,410	17,778	15,906	17,928	14,223	17,600	17,600
: Undeveloped Land	6,508	6,508	6,508	6,508	6,508		
TOTAL U.S.	40,478	35,216	31,969	33,684	29,475	17,600	17,600
CASHION GAS PLANT	3,900	3,700	3,300	3,900	3,700	3,300	3,300
DOLPHIN DRILLING	4,000	4,000	4,000	4,000	4,000	4,000	4,000
LPG MARKETING	1,000	1,000	1,000	1,000	1,000	1,000	1,000
OTHER ASSETS	2,000	2,000	2,000	2,000	2,000	2,000	2,000
WORKING CAPITAL	4,660	4,660	4,660	4,660	4,660	4,660	4,660
TOTAL ASSETS	225,043	173,612	143,750	177,336	138,546	160,652	126,721
LIABILITIES							
LONG-TERM DEBT	60,443	60,443	60,443	60,443	60,443	60,443	60,443
DEFERRED REVENUE	4,281	4,281	4,281	4,281	4,281	4,281	4,281
DEFERRED TAXES	3,640	3,640	3,640	3,640	3,640	3,640	3,640
CAPITALIZED OVERHEAD EXPENSES	-	-	-	33,500	19,500	33,500	19,500
TOTAL LIABILITIES	68,364	68,364	68,364	101,864	87,864	101,864	87,864
NET TOTAL ASSETS	$156,679	$105,248	$ 75,386	$ 75,472	$ 50,682	$ 58,788	$ 38,407
NET VALUE PER SHARE	$ 10.60	$ 7.12	$ 5.10	$ 5.11	$ 3.43	$ 3.98	$ 2.60

CASH FLOW ANALYSIS

Dalco's cash flow has declined from a peak of $0.49 per share in fiscal 1980 to a negative annualized rate of $0.15. The single most important contributing factor is interest which soared by over $10 million (or $0.68 per share on an annualized after-tax basis) during the past eighteen months. Excluding interest payments, cash flow would have actually shown a modest increase.

Part of the five-fold jump in interest expenses is due to the high rate (an average of 21% in the last six months) which the Company must pay but most relates to the U.S. drilling program which was totally financed with bank loans. As we pointed out earlier, the annual cash flow shortfall in the U.S. is currently $6.2 million or $0.42 per share. All other things being equal, cash flow would be closer to $0.40 per share than zero if the attractive netbacks in the States had been ignored.

TABLE IX

DALCO: CASH FLOW ANALYSIS
($ Millions)

	Year Ending May 31				Year Ending December 31	
	1980	1981	1st H'82 Annualized	1982E	1982E	1983E
INCOME						
Oil and Gas:						
Revenue	$ 7.2	$11.2	$11.8	$12.8	$14.4	$17.8
Expenses*	0.8	2.2	3.5	3.8	4.2	5.3
Gross Profit	6.4	9.0	8.3	9.0	10.2	12.5
Dolphin Drilling	1.8	1.8	2.3	1.5	1.5	2.0
LPG Marketing	1.9	0.9	0.6	0.4	0.5	0.5
Other	0.7	0.8	0.9	0.8	0.5	0.5
Total Income	10.8	12.5	12.1	11.7	12.5	15.5
LESS:						
General and Administrative Expenses	2.2	2.8	2.9	3.1	3.0	3.2
Interest on Long-Term Debt	2.4	5.9	12.5	11.7	11.0	10.5
Income Taxes	-	-	-	-	-	-
Alberta Royalty Tax Credit	(0.7)	(0.9)	(1.3)	(1.7)	(2.0)	(2.0)
Adj. for Other Non Cash Items	0.2	0.3	0.2	0.2	0.2	0.2
NET CASH FLOW**	$ 6.6	$ 4.3	$(2.2)	$(1.6)	$ 0.3	$ 3.6
Cash Flow Per Share	$0.49	$0.29	$(0.15)	$(0.11)	$0.02	$0.24

* Includes Petroleum and Gas Revenue Tax

** May not add due to rounding

Dalco's cash flow picture should improve in the second half of fiscal '82 but we are projecting less than a breakeven position for the year. Management plans to revert to a December 31 year end so a small positive cash flow for calendar '82 is likely but the big jump in cash flow back to or at least approaching the $0.25 per share level is expected in 1983.

First, under the N.E.P. agreement, natural gas prices are scheduled to increase by 25% effective November 1982. Second, U.S. cash flow should increase as more of the wells in East Texas are hooked up to gas pipelines and development wells are completed in Dewey County, Oklahoma. Third, interest expenses should decline somewhat as management has made a commitment to reducing the Company's financial risk exposure. Both the absolute amount of long-term debt and the interest rate should be lower in 1983. Each 1% decline in the prime lending rate will increase Dalco's cash flow by $0.04 per share.

A cash flow of $0.25 per share still does not reflect the Company's estimated asset value of $3 to $5 per share. Included in the asset value is $13.3 million (or $0.90 per share) of undeveloped land which management must either sell or arrange farmout drilling programs on, if the cash flow is to be maximized. Second, the 1983 forecast for Canadian oil and gas revenue assumes production at <u>only 80%</u> of the well potential, primarily due to continued cutbacks by TransCanada PipeLines. As gas prices continue to rise and production moves back to full capacity, cash flow should show further significant increases in 1984 and 1985.

<u>LONGER TERM OUTLOOK</u>

1. <u>Drilling Activity</u>

Dalco is already trading at a significant discount to asset value but successful drilling activity could still increase the reserve values by a modest amount.

a) East Texas

The engineering report prepared for Dalco on the East Texas play included only eight wells but, to date, the Company has drilled eleven successful wells. More confirmation of the property's value can be obtained from an agreement whereby a non-industry participant supplied $1.4 million toward the completion of five wells in exchange for an 11.9% working interest.

Also, in exchange for a 6% carried interest, Dalco acted as operator in the drilling of two wells offsetting a 3,000 acre block which is 95% owned by the Company. Each well is producing about 100 BOPD from the Pettet zone located at about 7,500 feet. Dalco has recently completed plans to drill four wells on its property. The first two are being farmed out at no cost to the Company. Dalco will retain a 25% carried interest in the first two wells and a 40% working interest on any additional offsetting wells.

b) Brazoria County, Texas

The Company holds a 25% W.I. in the 3,000 acre North Allen Dome prospect. The initial well indicated 32 feet of gas-bearing Frio Sand at 12,400 feet which compares favourably to offsetting projects producing 5,200 Mcf of gas daily. However, in spite of excellent top hole pressure, completion problems eventually forced the operator to abandon the hole. Management intends to participate in a redrilling program through a farmout arrangement.

2. Rationalization of Assets

Dalco's management is redirecting its efforts from expansion and diversification to generating a healthy cash flow and reducing the balance sheet risk. In this endeavour, assets which are currently producing only a modest or neglible cash flow are potential sale candidates. Cash raised from land sales would be used to reduce long-term debt rather than drill more wells. Farm out agreements, similar to those completed in East Texas, are being actively pursued in both Canada and the United States.

3. Ownership

Legal problems involving Mr. Louis Porter, the controlling shareholder of Dalco's parent, has restricted the Company's flexibility in the past year. However, a friendly change in the parent's control has been proposed through a merger with Lonnie Dunn International, a financially stronger southwestern energy and property developer. The merger is expected to be completed within the next two or three months.

Mr. Dunn is expected to bring a welcomed breath of fresh air to the Board of Dalco. In addition to his own business acumen, Mr. Dunn has excellent contacts in North America as well as Europe who could play a key role in the Company's future growth through farm out or joint venture agreements.

CONCLUSION

Dalco's heavy debt obligation appears to be more than adequately covered by an excellent proven reserve base in Canada and some exciting exploration plays in the United States. Investors are justifiably concerned with the current negative cash flow position but we believe that action by management to rationalize the asset base and significant gas price increases agreed to under the N.E.P. will lead to a strong recovery in cash flow next year. Lower interest rates would also help.

We can no longer justify pre-tax asset values based on a 15% discount rate but even using a 20% rate, a reduction for taxes and squeezing any water out of the U.S. asset values, we still arrived at an asset value per share of $2.60, or close to three times the current stock price. Therefore, we recommend purchase.

APPENDIX A

DECLINES IN OIL AND GAS SHARES

1980-81 HIGHS TO RECENT LOWS

Integrated Oils

	1980-81 HIGH	RECENT LOW	PER CENT DECLINE
Total (N.A.)	$36 1/2	$ 8 7/8	75.7%
Husky Oil	22	5 7/8	73.3
Gulf Cda.	38 3/4	10 3/8	73.2
Imperial Oil	57 1/2	19 5/8	65.9
Murphy Oil	43	15 1/2	64.0
BP Canada	59 1/2	22 1/4	62.9
Shell Cda.	41 1/4	15 3/4	61.8
Texaco Cda.	46 1/4	21 1/4	54.1
Average Decline			66.4%

Large Producers
(1980 Revenues in Excess of $100 million)

	1980-81 HIGH	RECENT LOW	PER CENT DECLINE
Turbo Res.	$12 1/2	$ 2.01	83.9%
Ranger Oil	27 1/2	5.00	81.8
Ocelot	69	14 1/2	79.0
Francana	32 1/2	8 1/2	73.6
Asamera	31 1/2	9.00	71.4
Alta. Energy	27 3/4	8.00	71.2
Dome Pete.	25 3/8	7 7/8	69.0
Dome Canada	11 1/2	3.70	67.8
Bow Valley	27	10	63.0
Cdn. Occidental	18 7/8	9 1/2	49.7
Norcen	41 1/2	21.00	49.4
Pan Canadian	98	51 1/2	47.5
Average Decline			67.3%

Medium Producers
(1980 Revenues from $10 to $100 million)

	1980-81 HIGH	RECENT LOW	PER CENT DECLINE
Nat'l Petroleum	$ 5 1/8	$ 0.48	90.6%
TransCan Res.	10 1/4	1.20	88.3
Dalco Pete.	6 3/4	0.85	87.4
Bluesky	18 3/8	2.51	86.3
Un. Canso	31 1/2	5.00	84.1
Blake	9	1.45	83.9
Coseka	32	5 1/4	83.6
Brent	15 1/2	2.75	82.3
Sulpetro	33 1/2	6 3/4	79.9
Conventures	21	4.40	79.1
Page	35	7 1/2	78.6
Oakwood	28 1/2	7.00	75.4

Medium Producers Cont'd

	1980-81 HIGH	RECENT LOW	PER CENT DECLINE
Numac	$ 53	$14 3/8	72.9
Campbell Res.	20 3/8	6 1/8	69.9
Trinity	25 7/8	8 1/8	68.6
Cdn. Reserve	33	10 7/8	67.1
Scurry Rainbow	113 1/2	39	65.6
Skye Res.	20	7.00	65.0
Roxy (Clarion)	6 7/8	2.55	62.9
Can. N. West	43 1/2	18 1/4	58.1
Merland	13 1/8	5 1/2	58.1
Westcoast Pete.	37	16	56.8
Chieftain Dev.	31 1/2	14 3/4	53.2
Average Decline			73.8%

Smaller Producers
(1980 Revenues from $5 to $9.9 million)

	1980-81 HIGH	RECENT LOW	PER CENT DECLINE
Czar	$21 7/8	$ 2.00	90.9%
Cdn. Nat. Res.	29	3.30	88.6
Bonanza	15	1.90	87.3
Petrol	14	2.90	79.3
Phoenix	30 5/8	6 5/8	78.7
Ranchman's	14 3/4	3.40	77.0
Camel	10 1/2	2.50	76.2
Pan Cana	11 1/2	2.85	75.2
MSR	18	4.55	74.7
Paloma	8 1/4	2.25	72.7
Sceptre	18 1/4	5 1/4	71.2
Stampede	10 1/4	3.20	68.8
Bighart	9 5/8	3.45	64.2
Yellowknife	10 1/4	5 1/4	48.8
Average Decline			75.3%

Junior Producers
(1980 Revenues from $2 to $4.9 million)

	1980-81 HIGH	RECENT LOW	PER CENT DECLINE
Can. Southern	31	3.30	89.4%
Rupertsland	$12 3/8	$ 1.51	87.9
Pennant	4.90	0.75	84.7
QMG	19 3/4	3.10	84.3
Ram Petroleum	28	4.75	83.0
Cherokee	16	2.75	82.8
First Calgary	6	1.10	81.7

	1980-81 HIGH	RECENT LOW	PER CENT DECLINE
Junior Producers Cont'd			
Dynamar	7 5/8	1.85	75.7
Quasar	8 1/4	2.15	73.9
Morrison Pete.	6 1/8	1.80	70.6
Inverness	7 7/8	2.75	65.1
G.M. Resources	7 1/8	2.50	64.9
Average Decline			78.4%
Mini Oils (1980 Revenues from $0 to $1.9 million)			
Delta	7 1/2	0.55	92.7%
Joutel	$ 9 3/8	$ 0.75	92.0
Noble	3.60	0.35	90.3
Rio Alto	6 1/4	0.61	90.2
Westmount	10 1/2	1.05	90.0
Drummond	8 7/8	0.90	89.9
Onaping	13 3/8	1.35	89.9
Seaward	4 1/4	0.45	89.4
Northstar	10 1/4	1.10	89.3
Joffre	7	0.79	88.7
Windsor	8 5/8	1.00	88.4
Spooner	2.70	0.32	88.2
Lava Cap	12 1/4	1.55	87.4
Liberty	5 3/8	0.70	87.0
Delhi Pacific	2.45	0.32	86.9
Corrida (MSZ)	14 1/4	1.90	86.7
Ego	2.73	0.38	86.1
Ulster	7 1/2	1.05	86.0
Lochiel	2.70	0.33	85.3
Chancellor	6 7/8	1.02	85.2
Commercial	5 1/2	0.85	84.6
Un. Westland	17 1/4	2.70	84.4
Gulfstream	12 3/4	2.00	84.3
Place G & D	3.45	0.57	83.5
Highwood	6 3/4	1.40	79.3
O'Brien	4.30	1.05	75.6
Westfort	4.30	1.10	74.4
New York Oils	3 3/4	1.00	73.3
Coho	15 1/2	4.55	70.2
Killucan	3 3/4	1.15	69.3
Gane	3 1/4	1.00	69.2
Scarboro	6 5/8	2.10	68.3
Strand	9 1/2	3.70	61.1
PreCambrian	8 7/8	3.55	60.0
Onyx	11 7/8	5 1/2	53.7
Bankeno	10 1/8	5 1/2	45.7
Average Decline			80.7%

	1980-81 HIGH	RECENT LOW	PER CENT DECLINE
T.S.E. PRODUCER INDEX:	7,905.24	3,440.54	56.6%
T.S.E. INTEGRATED INDEX:	3,974.73	1,471.13	63.0
T.S.E. OIL & GAS INDEX:	5,214.87	2,320.53	55.5