

Thursday → Holsten Club. - 10-12:30 p.m.

*Temiskaming Milk Committee*

***Purchase and Operation of Thornloe Cheese  
Feasibility Report***

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1 Kg of cheese - 8 Kgs of milk 375,000 Kg of cheese

Rocco Dano - Parmalat  
Costs -

## Executive Summary

The attached report represents my comments on the feasibility of the purchase and operation of the Thornloe Cheese Factory. The main factors outlined in this report are the condition of the market for the product, the potential environmental issues that may arise and the potential financial performance of the operation.

Thornloe Cheese to earn a profit and deliver a reasonable return for an investor. The proposal is very high risk however and that return will only be realized if in fact the operation can sell all of its production capacity and at a margin that is reasonable. The current market is not ideal for realization of that scenario and considerable work will be required to drive the operation in the proper direction.

There are two major areas of risk over and above that associated with normal business risk associated with taking over an operation of this nature. Those factors are:

1. An uncertain environmental regulatory situation that may have serious financial implications for small independent producers in the not too distant future. The extent of future regulation and its costs as far as the proposed Thornloe Cheese operation is concern can not be precisely estimated at this time.
2. More than half of the existing market for Thornloe is represented by the Vendor, now a competitor. There is the potential for that market to be withdrawn, or if accessible to consist of low margin sales. The new company will have the ability to rebuild that market with other customers, but it could be an uphill battle with a competitor with deep pockets.

There are several key priorities that remain to be dealt with quickly most particularly the ownership and management issues. The Provincial and Federal regulatory agencies will not proceed with their final determinations regarding the plant, nor will the lenders grant approval of financing until this issue is resolved. The most important steps for consideration are, in priority:

1. *Determination of the ownership of the new entity.*
2. *Retention of plant management and staff.*
3. *Extension of deadline for deposit to Parmalat.*
4. *Confirmation from Parmalat that all process and procedure documentation developed for the plant is being transferred to new owners.*
5. *Inspections by OMAFRA and CFIA ( see issues outlined under "Regulatory issues).*
6. *Further assessment of waste water disposition.*
7. *Letters of support/commitment from customers.*

8. *Agreement with Ray Beland Distributors regarding terms and conditions of supply to Ontario Market.*
9. *Agreement with Parmalat Rouyn-Noranda regarding supply, or alternatively placement of a Québec distributor.*

Should the committee, or preferably an ownership group decide to proceed further with the acquisition then this consultant will complete the business plan that will include further refinement of the forecasts, completion of a staffing strategy and completion of a marketing strategy.

Completed applications for Licensing from the Province, Registration with the Federal government and for funding requests for NOHFC and TEMFUND will be provided to a representative of the committee by Thursday November 23, 2006. This consultant has been in discussions with all the concerned parties on an ongoing basis. A draft letter will also be provided regarding support from retail customers in Northern Ontario. Mr. Cormier has agreed to deliver such a letter to his retailers, both independent and corporate and feels he will have no trouble getting his customers support.

The main issue in this consultants view comes down to the ownership of the project going forward.



## Assets to be Purchased

The proposed transaction represents a purchase of assets only, rather than the sale of an ongoing business, although in reality it represents a combination of the two types of transactions and the intent of the purchasers is to operate the existing business in a similar fashion on an ongoing basis. The assets to be purchased are of a number of types and include:

- The realty all manufacturing equipment, furniture and fixtures, computer hardware and software, leasehold improvements and vehicles.
- Certain inventory.\*
- Customer records, trade and operating practices and procedures etc.\*\*
- The Trade name “Thornloe Cheese” and goodwill associated with the name.
- A milk quota of 1.5 million litres.\*\*\*

*\*It is likely that Parmalat will exhaust most of the supplies on hand by closing and the value of inventories will I suspect be minimal. Two Inventory items of note are not included in the price, Milk and finished product. Any milk on hand at the plant on closing and any finished product will need to be paid for as an adjustment to the price.*

*\*\*Parmalat has supplied certain health and safety procedures and Cheese making procedures in their due diligence binder. However this consultant has asked the company specifically if all books and records located at the plant will be included in the purchase and have yet to be provided an answer. There is a wealth of information contained in these records that, if provided will ease the new operator’s transition. Confirmation should be sought at the earliest opportunity.*

*\*\*\*The Dairy Farmers of Ontario have indicated that they will provide an additional Milk Quota of 1.5 million litres bringing the total Milk Quota to 3 million litres. To date no formal written agreement is in place regarding the terms and conditions of that Quota. Such an agreement should be obtained at the earliest possible opportunity.*

The plant site is located on the east side of Highway 11 approximately 3 kilometres north of the junction of Highway 569. The property contains a total area of approximately 160 acres although the largest portion of that remains undeveloped.

The building is concrete block and wood frame and has no basement. A small retail and office area is located at the front of the building facing the highway and the cheese factory is located behind. The “storefront” contains three small offices and washroom facilities. A lunchroom, staff washroom and storage room are located at the Northeast end of the plant (rear) and boiler rooms, shop and electrical rooms are located at the south east end of the plant. There is a second storey at the south end of the building that contains a residence which is currently unoccupied. The current manager of the plant Fred Laffin had lived there until just recently.

Heat for the building and processing is provided by boilers fired by <sup>Propane</sup> ~~Natural gas~~. An oil fired boiler is also utilized as a back up.

The site is supplied with drinking and process water from an on site well that delivers some 40,000 litres per day. Sewage waste is handled by a septic system that was installed according to the company in the late 1990's. Process wastes are however currently being piped directly to the forested area behind the main building. (discussion under "Environmental Concerns").

The manufacturing equipment includes a wide range of stainless steel storage and processing units as well as pumps, compressors, product handling and packaging facilities. A complete list of all production equipment has been provided by Parmalat including model and serial numbers where applicable. Overall the condition of the equipment appears to be good, but it is old. More efficient and cost effective equipment is available, but it would be hard to justify the expenditure based on the current situation, i.e. for the limited quota available.

In addition to the production equipment the following additional equipment is included in the purchase price:

Store Equipment

Pop Fridge  
Ice Cream Display Freezer  
Horizontal Freezer  
Curd Cheese Cooler  
Block Cheese Cooler  
Cheese knife  
Scale  
Cash Registers (2)  
Air conditioning units  
Coffee Machine

Office Equipment

Computers (3)  
Printing Calculators (4)  
Brother printer/photocopier  
Hewlett Packard Printer  
Office Desks (2)  
Office Chairs (3)  
Phones 95)  
Safe  
Paper shredder  
Overhead projector & screen  
Punch clock

Laboratory Equipment

Babcock centrifuge  
Antibiotics testing kit  
Assorted glass ware and solutions for testing

Lunchroom Equipment

Microwave ovens (3)  
Refrigerator  
Mini fridge

The company also leases equipment and new operators will have to make arrangements with suppliers, prior to closing to ensure a smooth transition. That equipment and the necessary action is listed below:

- A raw milk sample fridge from the University of Guelph, Laboratory Services Division. They need to be notified of closing date. New owner must re-apply to DFO.
- Nestle Ice Cream Freezer from Nestle Canada. The leasing agreement can be transferred, but the new operator will have to apply to Nestle. If not required 2-3 weeks notice are required for pick up.
- Propane tanks are supplied by Superior Propane. The new Operator will have to apply for a new account. Having that approved Parmalat can either have the tanks filled on closing and charge new operator for full tank or have superior Propane come out and take a reading and transfer the balance. 3 weeks notice required.
- The Oil Tanks are owned by UPI. The account is transferable but must be applied for.
- Nitrogen Tanks are owned by BOC Canada Limited. Can be transferred but new operator must apply. Three weeks notice.
- The photocopier/fax machine is supplied by Xerox.
- The Interac Machine must be returned to CIBC. The account is not transferable. The new operator should make arrangements with its own bank for Visa and interac machines, which are certainly required.

Contact names & numbers are available.

Final allocation of asset price is to be determined between the seller and the buyer and to be included in the Asset Purchase Agreement. For the purpose of the preliminary financial forecasts presented as part of this report I have allocated the purchase price as follows:

Land	\$ 20,000
Building	280,000
Production Equipment	440,000
Other Equipment	<u>10,000</u>
Total	\$750,000

### **Regulatory Issues**

The Thornloe plant is licensed by The Province of Ontario under the Milk Act of Ontario. The license the plant operates under is not transferable to new owners rather a new license will need to be issued. An application form for the license has been completed and must be submitted together with a fee of \$150.00. Prior to issuing a new license the Director of the Food Inspection Branch of the Ontario Ministry of Agriculture, Food and Rural Affairs (OMAFRA) must have verification that the plant is in compliance with the Milk Act and relevant regulations. This will be assessed by a pre-licensing audit of the facility. Any deficiencies identified through this audit must be addressed through a detailed corrective action plan that must be submitted for the Ministry's approval.

The Thornloe plant is also currently a federally registered facility which enables the plant to ship product out of Province. The plant also has HACCP recognition from the Canadian Food Inspection Agency (CFIA). HACCP is an acronym for Hazard Analysis Critical Control Point. HACCP is an internationally recognized system that is designed to prevent contamination of food in the preparation process by control of that process. The system is based on "Critical Control Points" and the prevention of identified hazards through control of those points. It is recognized in the food industry as a real positive quality control factor for production plants.

There is an annual fee for the Federal registration that includes annual inspection, based on the size of the operation. The Thornloe plant's annual registration fee is \$895.

Both the Provincial and the Federal Inspectors have been contacted on two occasions. We had been holding off scheduling a formal inspection date because Parmalat had not consented. They did so just last week on November 13, 2006. The Provincial inspector is prepared to break the inspection into two parts. The facility now and the ownership, management and procedures at such time as they are finalized. The Federal inspector would prefer to wait until closer to closing. I have advised the inspectors that I would contact them again after our meeting this week.

In addition to these industry specific agencies, other regulatory bodies include the Timiskaming Health unit, Ontario Ministry of the Environment and Ontario Ministry of Labour.

### **Environmental Concerns**

A Phase I Environmental Assessment was conducted by Mr. George Duncan of A & A Environmental Services Inc. That assessment turned up a number of concerns that should be addressed, or at a minimum understood by the purchasing parties.

The major issue involves the current disposition of the liquid effluent from the processing plant. There are a number of separate and distinct concerns around this particular issue. Firstly what it implies now and secondly potential changes in the future. Process wastes from cheese production are currently fed through a pipe to the forested area behind the main building. This as we all know has been the big "unknown" for potential future costs.

Currently wastes from cheese making facilities are exempt from having to be registered as wastes under Regulation 347 to the Environmental Protection Act. Under the "Registration Guidance Manual for Generators of Liquid Industrial and Hazardous Waste, section 15 (b) states:

"Non-hazardous wastes from the processing of food are exempt. These wastes can include those from food packing, food processing, food preserving, wineries and cheese making facilities. Grease and other liquid wastes from restaurants and other food preparation facilities are also included in this exemption."



Regardless of the exemption from registration and therefore development of a specific mandated disposal method. The EPA also is quite clear that anyone causing an environmental "adverse effect" is guilty of an offense and the definition of offense can be broad. We assume that there is no hazardous material in the wastewater stream; however the plant does make use of several hazardous and environmentally harmful chemicals, including chlorine, ammonia and acid based detergents, descalers and cleaners, which may end up in the effluent stream, although in highly diluted form. Given the porous nature of the underlying limestone bedrock at the site there is a risk that the plant effluent could contaminate the groundwater aquifer.

Mr. Duncan in his report recommends that a Phase II Environmental Assessment be undertaken. As an interim step it is suggested that A & A Environmental Services Inc. be engaged initially to sample and have analyzed the effluent at the source of discharge to determine the level of contaminants present. That should provide a good understanding of the requirement for a further assessment.

I have spoken with A& A about the costs of such tests and have been given a verbal estimate of \$200-300. Certainly this cost would seem a cost effective next step. The cost of a full Phase II Assessment could range from between \$10,000 - \$20,000.

The second issue around the wastewater discharge from the plant, although not discussed in the Phase I assessment is the continued viability of the current disposal system. Disposition of process waste water is a current hot topic with the Ministry of Agriculture and food and the Ministry of the Environment and proposed regulation governing the handling of process effluents is pending. A number of independent Cheese makers in the province have been working with the Ministries in respect to this issue and at the current time it is unknown what the requirement will be, and at what time regulation may be implemented.

The Ministry's office in Timmins has expressed Concerns regarding the issue, now that they have become aware of the status of the Thornloe plant, and may not be completely up to speed on the plans for the future. They have expressed a desire to inspect the site, but have been prepared to wait and see what happens with the current purchase negotiations. They are certainly interested in determining what impact if any the discharge of the process effluent is having.

This particular issue is perhaps the largest "hidden risk" associated with moving forward on the purchase. Should the province require construction of a lagoon to hold process effluent for treatment or off site shipment, the costs will be significant. A cheese manufacturer in South eastern Ontario has estimated the cost for his operation to be in the range of \$1 million. His annual production is something over 4 times that anticipated by Thornloe. Similar facilities for Thornloe would be no doubt less costly, however at this point it is impossible to put a dollar figure on it. There is also the possibility that the province may institute some kind of subsidization of the cost in order to assist small producers with the transition. Further details will be provided on this issue over the next two weeks.

There were three other issues identified in the Phase I assessment:

1. The on site well is capable of taking more than 2.9 litres per second of water which requires a "Permit to Take Water". Ontario Clean Water Agency was contacted about this and they advised that in lieu of a permit they could install a choke which would prevent the pump exceeding 2.9 litres per second.
- ✓2. The drinking water system at the site has not been historically monitored nor registered with Ontario Ministry of the Environment. MOE confirms that because the site provides washroom facilities to the public it constitutes a "Small Non-Municipal, Non Residential Drinking Water" system and it is therefore required to be registered with the MOE and provide water analysis data to the Ministry.
3. The ceiling and upper walls in the storage room for packaging material are covered with "Transite Board" which is known to contain asbestos (in the range of 12-50%. At the time the Phase I EA was done the board was unpainted and therefore represented a hazard of exposure to asbestos fibre. Parmalat advises that the board has now been painted with a sealant paint. Any attempt to remove this board must be carried out by a licensed contractor and the board should not be drilled or broken or handled in any way that may give rise to dust. It would be advisable to post warning signs over this particular area notifying any anyone that the board contains asbestos and should not be drilled or handled.

These issues are manageable and discussions with the parties involved will provide information on additional costs, if any, required to rectify the situation.

## Operations

Milk is received at the plant two to three times per week depending on production levels. It is the Cheese maker's responsibility to determine that the milk in the silos is fresh and that it remains in constant agitation. The milk is standardized to a butter fat target and is pasteurized at 165°F degrees Celsius for 16 seconds. Pasteurized milk is pumped into long stainless steel vats. A culture is then stirred into it and after a period of time a microbial enzyme is added to set the vat. Once curds have formed the whey is drained from the vat. When the curds have settled to the bottom of the vat they are cooked, stirred and then ditched to allow any remaining whey to be drained. The curds are allowed to mat, being turned and piled by hand a number of times to promote the proper texture and moisture content. The mats are cut into strips or sheets and run through a curd mill. They are then stirred and heated one more time and salted and other spices are added that may be required depending on the type of cheese.

At this point curds that are to be sold as curds are bagged for distribution. The remaining curds are then placed in forms and set in a press to form block cheese. Cheese from these forms then goes to the cut and wrap station where it can be cut to size and vacuum packed. All packaging must include a product and content description, the nutritional information panel for the product, and a best before date label. Beyond this station is a monitored cheese cooler room where the product is stored for sale or pending transportation.

Pasteurized Whey resulting from the process is currently stored in holding tanks at a temperature no greater than 55°F. Thornloe currently ships its whey to Parmalat plant in Québec. There are alternatives including identifying another processor to take the whey, or in fact identifying a local farmer who will take the whey for his/her fields. Spreading whey on agricultural property remains common practice in the province.

The cheese maker's touch is very important throughout the process, involving constant monitoring and testing particularly in the cooking and formation of the curds. The Thornloe Plant utilizes three full time cheese makers in processing. In total the permanent compliment is 10 full time staff plus the plant manager and that complement is broken down as follows:

Head Cheese Maker	1
Cheese Maker	1
Assistant Cheese Maker	1
Milk Receiving and Pasteurization	1
Cutting & Packing	2
Warehouse & Shipping	1
Counter Staff	1
Bookkeeping & Accounting	<u>2</u>
	10

*Dallaire Girls*  
*- 4 or 5 employees*  
*2 or 3 times a week.*

In addition to the permanent staff the operation utilizes regular part time staff and temporary staff as well as some student labour in the busy summer months for the tourist trade. There are likely some economies to be realized with staffing dollars. The pay rates and benefits that Parmalat offers constitute a larger package than the new operators can afford to pay. The current cheese makers are an important part of the process however and decisions on the pay package should be withheld until such time as interviews can be carried out.

## **Products, Market and Competition**

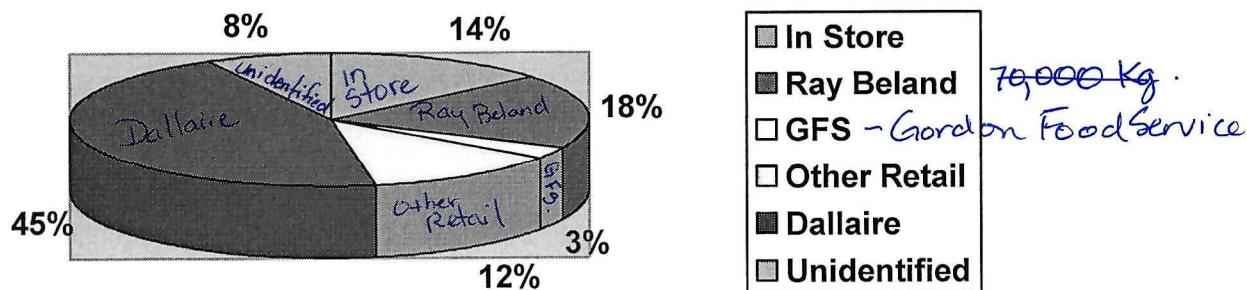
In a previous report I outlined some characteristics of the Cheese market in Canada, the major players and product comparisons between competitive products that can be found within Thornloe's geographical market area. I won't repeat that here other than to reiterate that the product being produced by the plant is one that very much requires a regional marketing strategy and one that has to some extent geographical boundaries. There are a couple of factors that cause that. Firstly cheese produced in different areas has different characteristics, primarily due to the milk utilized in the process which in turn can be determined by soil conditions, feed etc. Consumers of independent cheese makers tend to be accustomed to and have a preference for the cheese from their area. Secondly Northern Ontario does not have the corner on regional loyalty and consumers in the Southeastern part of the province are going to support Maple Dale or Ivanhoe, and consumers in the South west are more likely to support the local producers in that area.

Even in the North there are distinctions. Sault Ste. Marie is recognized as Saputo's market, because of their presence there and the large Italian component of the population.

The products that the Thornloe Plant produce consist of a variety of cheeses, including cheddar, Colby, and American mozzarella. Their biggest claim to fame is cheese curds and block fresh cheddar. The plant does not produce any aged cheese. Any Thornloe product that bears the designation of medium, old or extra old has in fact been produced at another location. These other cheeses are important to Thornloe in order that they can supply a range of product to their customers that is expected. These cheeses are currently obviously supplied by Parmalat, however that may not be the most effective or cost efficient practice for the future.

The current operation has several distinct market segments. The following chart indicates an estimate of where Thornloe's manufactured product went last year based on information provided by Parmalat and through verification from major customers. I will stress that this is an estimate on my part as the information Parmalat provided on sales both in volumes and dollars was incomplete, especially as it relates to internal Parmalat information. Never the less I think the breakdown is within reason, and certainly identifies the priorities for the future operations. I estimate that using the conversion factors that the company has been able to achieve over the last 12 months total production in 2005 was approximately 420,000 kg.

### Distribution of Production



Unidentified users include many small customers that utilize Thornloe cheese for summer chip stands, fundraisers etc. It also includes an unidentified portion of production that represents internal use by Parmalat. Customers and sales going forward is more important but this type of historical analysis identifies some challenges:

1. 50% of the existing market is represented by the Vendor. This may not become an issue, but has the potential to be a significant market hurdle. Further discussion is presented below.

2. Not all markets are of the same quality. In 2005 sales from the Thornloe Store netted an average of \$14.38 per kilogram, while on the low end of the scale sales to GFS averaged \$8.55 per kilogram. These sales plus those to Dallaire are very low margin when the cost of production is considered.

This consultant has estimated a cost of production going forward that could be in the range of as low as \$8.30 to a high of \$8.81 per kilogram through the forecast period. Based on performance in 2005 I have calculated the average cost of production for that year at \$8.31 per kilogram of cheese. (further discussion in section entitled "financial Analysis").

6.90  
.19  
.35 Pack.  
.76 Direct  
labour

The major customer segments, production pricing and sales for last year indicate the following:

\$8.31

Customer	Volume	Total Sales	Avg. Price Per Kg	Margin per Kg	Gross Margin
In Store	59,970 kg	\$ 862,369	\$14.38	\$ 6.07	\$ 364,018
Ray Beland	76,802 kg	786,841	\$10.25	\$ 1.94	148,996
Dallaire	189,017 kg	1,809,954	\$ 9.57	\$1.36	257,063
GFS	11,004 kg	94,131	\$ 8.55	\$0.24	2,641
Other	83,000 kg	822,530	\$9.91	\$1.60	132,800
Total	419,793 kg	\$4,375,825			\$905,518

Gordon Food Service

In store retail sales represent only a small fraction of volume 14%, a larger portion of sales, 20% but most importantly 40% of the gross margin generated by the operation. There are additional costs involved in keeping the retail operation going of course, but these are not large in the overall scope of the operation and it is assumed that maintaining the store is a priority. This breakdown illustrates the need to focus on increasing store sales of manufactured product and in pushing a higher percentage of wholesale trade to higher margin products. The new operation will have considerably less production to work with 3,000,000 litres of milk vs. a little over 3,500,000 that Thornloe processed last year. That will bring sales and gross margin down of course, but if the decrease can come in the right customer group the impact can be minimized.

Thornloe Cheese is currently sold in grocery stores in Northeastern Ontario from Sudbury through to Timmins. By Ray Beland Distributors Ltd. (Chris Cormier). There are some sales beyond these wide parameters, but they are minimal. The Thornloe Cheese business is very important to Mr. Cormier, representing as much as a third of his business and he is extremely anxious to maintain the distribution relationship. He has also not been terribly thrilled with his relationship with Parmalat, especially during the past few months. He and his retailers are anxious to have a long term commitment of supply.

The majority of other retail customers in Ontario consist of very small operations, gas bars with grocery sections, small convenience stores and farmers' markets. Mr. Cormier feels that under his current agreement with Parmalat any retailer in Ontario should be reached though Ray Beland Distributors. This is an item to be fleshed out in future negotiations. There are also a small number of retailers on the Québec side of the border very near to the crossover point from Ontario that the company sells to independently.

The major client in Québec is Dallaire (Parmalat). The consultant has been in contact with Ghislain Lefebvre, the manager responsible for the operation. For him the issue comes down to price. He complains that Thornloe is already over priced.

Mr. Lefebvre claims to be able to buy his cheese from other suppliers in Montreal @ \$16.20 per 2 Kg. package. At \$8.10 per kg that is well below Thornloe's cost of production, and the plant could not hope to compete. The issue again comes back to "quality" and I questioned the quality and freshness of that product he may receive versus that from Thornloe and what his customer base would support. This is the toughest market segment to establish as an ongoing source of revenue. If one was to question the ongoing motive of Parmalat as far as competitive pressures go, it would be the easiest market to take away from Thornloe. It is also the one in which the new operation will have the most difficulty competing price wise.

There are other alternatives for reaching the Quebec market including establishing relationships with an existing distributor for the region. There could however be issues around name recognition in some areas replacing Dallaire with Thornloe, and the key marketing strength of a Northern Ontario regional product may be lost to these customers.

In addition to the cheese products manufactured by Thornloe the current operation also sells cheese that is currently made by other Parmalat producers. Any cheese on the market with a designation of "Medium", "Old" or "Extra Old" has been manufactured somewhere other than the Thornloe plant. These cheeses are not as large as a component of sales, but are an important addition to the product line to ensure that Thornloe can supply the range of product that customers demand.

Approximately 20,000 Kg of these cheese products were sold to Ray Beland Distributors last year and the average price per kilogram was very similar to Thornloe's product, approximately \$10.26 per Kg. 24,794 Kg was sold in Thornloe's store, about 41% of the manufactured product sold. The average price per Kg of store sales was much higher though at \$16.90. One could expect to generate additional revenues from sale of other cheeses.

The third area of revenue generation for the operation is in store sales of other products. To date this has been a relatively minor source of income. In 2005 revenue from other products totaled approximately \$85,000 and was generated from the sale of pop, chips and ice cream. This is the one area of the current retail operation where significant growth is possible. The current operation has a very small retail area and sells only the few noted items over and above cheese. There is both a behind the counter freezer for scooped ice cream and a freezer supplied by Nestle in the store containing proprietary products.

The majority of regional cheese producers that operate retail operations have much more elaborate retail storefronts which carry a wide range of product, usually, but not exclusively from other producers within the local area. While there potential revenues to be realized from increasing the number of products in the store, the tactic is also important as it will draw more people in to buy cheese (at retail prices). If one were to visit Maple Dale Cheese or Ivanhoe Cheese in Eastern Ontario or Pine River in Kincardine for example one would find a very inviting retail premises with a wide variety of both cheese and non cheese products. Gift baskets are very popular, especially at holiday times such as thanksgiving and Christmas and can net significantly increased returns, as much as 3 times the normal price per Kg of cheese with minimal additional packaging and material costs.

The consultant is currently exploring the potential to develop this business.

## **Financial Performance**

Debt financing for the operation should not be an issue. Both the Northern Ontario Heritage Fund and The Temiskaming Development Fund Corporation have indicated they would be prepared to assist. I was concerned that the Heritage Fund might not consider Milk Quota as an eligible cost and this may yet be an issue, however I have discussed this with both management at NOHFC and their due diligence provider and they have indicated that they are prepared to consider it although that is not a guarantee at this point..

The following costs and financing are in my view reasonable:

<u>Costs</u>		<u>Financing</u>	
Purchase of Plant		Shareholders' Equity	\$ 520,000
And Equipment	\$ 750,000	NOHFC	750,000
Inventory	200,000	TEMFUND	450,000
Working Capital	20,000		
Milk Quota	<u>750,000</u>		
Total	<u>\$1,720,000</u>	Total	<u>\$1,720,000</u>

Additional Capital Costs may be required as a result of OMAF and CFIA inspection. Any deficiencies will require a remediation plan. Discussions with those agencies indicate that any costs associated with remedial action would likely be minimal.

February is typically a fairly slow sales and production month according to company records. Assuming very little inventory is left on hand by the departing vendor, an initial inventory build up of \$200,000, primarily the month's milk requirements, should be adequate until cash from sales begins to come in.

Appendix 'A' attached to this report includes the financial forecasts for the operation. The majority of assumptions are outlined therein and I will discuss them in detail at our meeting. A summary of key financial data for the first three years is presented below:

## Outstanding Issues

The following issues remain as priorities:

- *Determination of the ownership of the new entity.*
- *Retention of plant management and staff.*
- *Extension of deadline for deposit to Parmalat. Dec. 8/06*
- *Confirmation from Parmalat that all process and procedure documentation developed for the plant is being transferred to new owners.*
- *Inspections by OMAFRA and CFIA ( see issues outlined under "Regulatory issues).*
- *Further assessment of waste water disposition.*
- *Letters of support/commitment from customers (-from Chris Lornier)*
- *Agreement with Ray Beland Distributors regarding terms and conditions of supply to Ontario Market.*
- *Agreement with Parmalat Rouyn-Noranda regarding supply, or alternatively placement of a Québec distributor.*
- *Do affluent tests \$200-300 - waste water issues.*
- *Check into lease-out of quota as opposed to making cheese that is selling at or below the cost of production.*



## Conclusion and Recommendation

The business opportunity provided by the purchase of Thornloe Cheese factory is one which has the potential to be profitable and generate a return on investment. There is a very high level of risk associated with the venture however. The two major areas of risk over and above that associated with normal business risk associated with taking over an operation of this nature are:

- An uncertain environmental regulatory situation that may have serious financial implications for small independent producers in the not too distant future. The extent of future regulation and its costs as far as the proposed Thornloe Cheese operation is concern can not be precisely estimated at this time.
- More than half of the existing market for Thornloe is represented by the Vendor, now a competitor. There is the potential for that market to be withdrawn, or if accessible to consist of low margin sales. The new company will have the ability to rebuild that market with other customers, but it could be an uphill battle with a competitor with deep pockets.

The key priorities outlined above need to be dealt with quickly, most particularly the ownership and management issues.







**Thornloe Cheese Factory  
Forecast Cheese Production Analysis**

Sales Data	2005				
	Year One	Year Two	Year Three	Year Four	Year Five
Estimated Quota Processed	3,000,000	3,000,000	3,000,000	3,000,000	3,000,000
Estimated Production in Kg	363,636	363,636	375,000	375,000	375,000
Conversion Milk to Cheese	8	8.25	8	8	8
Estimated Sales Retail-Kg	59,953	60,000	66,000	70,000	72,000
Estimated Sales Wholesale-Kg-Ort	170,806	150,000	150,000	155,000	135,000
Estimated Sales Wholesale-Kg-Pq	18,9017	153,636	147,636	150,000	146,000
Estimated Sales Purchased Cheese Retail-Kg	24,794	25,000	26,250	27,037	27,649
Estimated Sales Purchased Cheese Wholesale-Kg-Ort	19,599	25,000	25,000	31,000	32,000
Estimated Sales Purchased Cheese Wholesale-Kg-Pq	n/a	n/a	n/a	30,000	32,000
Estimated Sales Retail-\$	\$662,124	\$870,000	\$957,000	\$1,099,500	\$1,134,000
Estimated Sales Wholesale-\$-Ort	1,537,500	1,537,500	1,537,500	1,634,890	1,627,500
Estimated Sales Wholesale-\$-Pq	1,419,019	1,471,833	1,414,353	1,462,300	1,517,000
Estimated Sales Purchased Cheese Wholesale-\$-Ort	412,500	443,625	443,625	459,629	473,433
Estimated Sales Purchased Cheese Wholesale-\$-Pq	256,250	256,250	256,250	315,000	325,500
Total Cheese Sales	\$1,281,143	\$4,546,093	\$4,608,728	\$4,911,479	\$5,011,433
Average Price per Kilogram Retail MFG	\$14.38	\$4.50	\$14.50	\$15.00	\$15.75
Average Price per Kilogram Wholesale MFG-Ort	\$10.25	\$10.25	\$10.25	\$10.50	\$10.50
Average Price per Kilogram Wholesale MFG-Pq	\$9.38	\$9.58	\$9.58	\$9.75	\$10.25
Average Price per Kilogram Retail Purchased	\$16.90	\$16.50	\$16.90	\$17.00	\$17.00
Average Price per Kilogram Wholesale Purchased-Ort	\$10.25	\$10.25	\$10.25	\$10.50	\$10.50
Average Price per Kilogram Wholesale Purchased-Pq	n/a	n/a	n/a	\$10.50	\$10.50

**Direct Costs**

Daily Ingredients	\$6.90	\$2,509,091	\$6.90	\$2,527,273	\$6.95	\$2,684,438	\$7.16	\$2,700,000	\$7.20	\$2,718,750	\$7.25
Non-Dairy Ingredients	\$0.19	72,727	\$0.20	72,727	\$0.20	77,250	\$0.21	78,750	\$0.21	78,750	\$0.21
Packaging	\$0.35	134,545	\$0.37	134,545	\$0.37	142,913	\$0.38	142,500	\$0.38	146,775	\$0.39
Decladur	\$0.76	275,364	\$0.76	280,000	\$0.77	297,413	\$0.79	303,750	\$0.81	312,863	\$0.83
Dovegdevel/Waste	\$0.11	43,636	\$0.12	40,000	\$0.11	42,488	\$0.11	43,762	\$0.12	45,075	\$0.12
Total	\$8.31	\$3,035,364	\$8.35	\$3,054,545	\$8.40	\$3,244,500	\$8.65	\$3,268,762	\$8.72	\$3,302,212	\$8.81
Margin on Manufactured Cheese	842,969		18.53%	854,307	18.54%	892,350	18.17%	943,738	18.83%	976,288	19.19%
Cost of Purchased Cheese	512,500		525,313	598,889	617,915	628,415	677,915	681,019	681,019		
Margin on Purchased Cheese	156,250		174,563	175,741	181,019	181,019					
Total Margin on Cheese Sales	\$999,219		21.97%	\$1,028,870	22.32%	\$1,098,091	21.75%	\$1,124,756	22.44%	\$1,157,306	22.75%

Thornloe Cheese Factory Forecast - Other Retail Products	2005				
	Year One	Year Two	Year Three	Year Four	Year Five
Other Retail Sales	85,824	85,000	85,000	85,000	85,000
Beverages					
Potato Chips					
Ice Cream					
Butter					
Total Existing	85,824	85,000	85,000	85,000	85,000
New Product					
New Product					
New Product					
New Product					
Total New	0	50,000	75,000	100,000	100,000
Total Other Retail Sales	85,824	135,000	160,000	185,000	185,000

Cost of Sales Beverages for Resale Potato Chips for Resale Ice Cream for Resale Butter for Resale New Product New Product New Product New Product Total Total Cost of Products for Resale Margin on Resale Products	2005				
	Year One	Year Two	Year Three	Year Four	Year Five
Beverages for Resale					
Potato Chips for Resale					
Ice Cream for Resale					
Butter for Resale					
New Product					
New Product					
New Product					
New Product					
Total	70,000	115,000	130,000	152,000	152,000
Total Cost of Products for Resale	\$70,000	\$115,000	\$130,000	\$152,000	\$152,000
Margin on Resale Products	\$15,824	\$20,000	\$30,000	\$33,000	\$33,000