



Northern Rivers Capital Management Inc.
 Royal Bank Plaza
 North Tower, Suite 2000
 200 Bay Street, PO Box 66
 Toronto, Ontario
 M5J 2J2 Canada

January 21, 2008

Tel: 416.597.1226
 Toll Free: 1.866.902.7060
 Fax: 416.597.8926

Dear Partners and Friends:

The Northern Rivers Innovation Fund LP (the Innovation Fund) was up 5.16% in December, and the Northern Rivers Innovation RSP Fund (RSP Fund) was up 6.13%, meaning we ended 2007 down 2.36% in the LP, and essentially flat (+0.07%) in the RSP Fund. The Innovation Fund is now up 32.85% annualized over 3 years, and 34.71% annualized over 5 years, while the RSP Fund (with a shorter track record) has almost the same 3-year annualized return as the LP at +32.90%.

Average Annual Returns as at Dec. 31, 2007*

	2007 YTD	1 mo.	3 mo.	6 mo.	1 Yr.	3 Yr.	5 Yr.	Inception**
Northern Rivers Innovation Fund LP	-2.36%	5.16%	3.82%	-3.59%	-2.36%	32.85%	34.71%	29.37%
Northern Rivers Innovation RSP Fund	0.07%	6.13%	3.99%	-3.09%	0.07%	32.90%	n/a	21.76%

**Northern Rivers Innovation Fund LP inception date: May 8, 2001.
 Northern Rivers Innovation RSP Fund inception date: March 1, 2004.

I just finished reading Alex Ruus' year-end 2007 letter, and I find myself thinking that I wish I was in his position: he followed up his 42.13% return in 2006 in the Northern Rivers Conservative Growth Fund LP with a 14.66% return in 2007; with his Northern Rivers Global Energy Fund LP, he followed up his +12.97% performance in 2006 with an outstanding +30.44% in 2007. My hat is off to you, Alex, and I am proud to be your partner.

Many are trying to comfort me at the end of 2007 by telling me that being flat in 2007 after being up 92.5% in 2006 is "actually pretty good." Someone pointed me to the Financial Post from this past Saturday, in which it was cited that Canadian pension plans on average delivered 1.5% in 2007, saying (to paraphrase) "hey, if you can do 90% one year, then follow it up with a pension fund-type return, go easy on yourself." Unfortunately, I can't. What I *do* try to keep in mind is that our goal has always been to deliver superior absolute and relative performance on any trailing two year timeframe (hence the two-year lock-up for the LP). So far, we have met that goal, and I will do my very best to continue to do so.

I am preparing to invest more of my money in my funds at the end of February or March

With last week's dramatic 4%-6% declines in the major equity indices now putting the Dow and S&P 500 each down about 15% from their *all-time* highs (that were hit as recently as October 9th!!), the times we are now in appear much more akin to 1990-91 than any kind of 'soft' or 'bumpy-landing' scenario. The unwinding of the 1988-1990 real estate bubble and

S&L crisis has some reasonable parallels to today: the resulting recession led to a scary 20% decline in the S&P 500 from the all-time highs on July 16th 1990 to the bear market low on October 11th 1990. (It is remarkable that a nine month recession was priced into the markets in a matter of three months!¹) Interestingly, many internal market measures are now showing readings as extreme as those that occurred in October 2002 and October 1990. The “bright side” of such extreme measures is that they occurred at the bottom of the past two major bear markets; the “bright side” of seeing 1990 as a template for the current declines would mean that we are ¾ of the way through the declines, and that the worst should be priced in sometime between the end of January and the beginning of March. As such, I am preparing my personal affairs to be able to invest more in the funds I run at the end of February or March.

2007 in review; 2008 look ahead

Historically, I have done a macro review-and-look-ahead in the first letter of the New Year, and a micro (stock specific) review-and-look-ahead in the second letter of the New Year. This year, I am reversing the order. (The paragraph immediately above gives you a bit of a preview of what I am now expecting in the economy and markets, and how I plan to take advantage of whatever declines lay ahead.)

Before I begin a discussion of the core positions, it is probably helpful to re-visit the portfolio management approach that I use. I call it the Core/Farm Team approach. I will quote from the February 15, 2007 letter where I first described it: “What I am trying to achieve with the Innovation Fund (and RSP version) is to build a concentrated portfolio of core, long-term holdings that I am willing to ride through significant ups and downs (accumulating or trimming the positions as weightings dictate) because they share one common trait: each has what I believe to be a ‘sustainable competitive advantage’.

The core positions will typically comprise 50%-75% of the portfolio, with individual weightings typically in the 5% to 15% range. There may be as few as five core positions; I have never had more than eight at any one time. The “farm team” is typically 30-40 other stocks, with individual stock weightings typically in the 0.5% to 3% range, making up the other 25% to 50% of the portfolio. The “farm team”, as the name suggests, is the part of the portfolio in which I am scouting for core positions as I do the rolling due diligence on the positions there. Turnover on the farm team is high, probably 100% or more per year. Turnover in the core area is very low and would ideally be zero. I think it is significant that, almost six years into the life of the Innovation Fund, there are only six or seven positions that I currently consider core. This hints at how rare “sustainable competitive advantage” is, and why it is a cornerstone of what I am trying to get at in my due diligence process.”

I should also point out that I am managing through difficult markets as I always do: actively managing a hedge overlay of shorts and puts; using non-core positions as sources of cash; and picking away gingerly at core stocks as they decline (as long as their ‘core investment hypothesis’ is intact!)

2007 stock by stock: what worked, and what didn’t in the core, and a peek to 2008

¹ The 1990 recession lasted from July 1990 to March 1991; oddly, the U.S. markets reached their all-time highs on July 16th 1990, and reached their bear market low, 20% down, in October, a full six months before the recession was over! Perhaps that is what can give us hope that the markets can begin rising sustainably sometime in the next two to eight weeks, even as the bad news gets worse and worse.

Vendtek Systems and Aeromechanical Services graduated from the farm team to the core

Both companies had great years in 2007, as their stocks both rose well over 100%, and as fundamental developments proved up both companies' "sustainable competitive advantage", allowing them to move into a more rapid phase of their secular growth paths.

To paraphrase a tech/special sits analyst who follows Vendtek: "Vendtek achieved more significant company-changing milestones in 2007 than any company I follow." Their three-pronged expansion into the US was a remarkable achievement that, alone, provides a powerful platform for growth in 2008 and beyond. Their launches in China and Sudan were also notable milestones in 2007, adding to the growth they saw in their existing business in Canada and the UAE.

For 2008, the company has indicated to analysts that a regional agreement—encompassing such countries as Saudi Arabia and Egypt—should be consummated within the first quarter. These two countries alone have over two billion cellular pre-paid card "re-loads" a year. Once Vendtek gets traction with their partner in those two countries, their transaction-based revenue model (per re-load) starts generating significant free cash flow very quickly. The beauty of Vendtek's business model as it expands outside of Canada is that all it is doing is providing its software and assisting in setting up systems that allow its partners in the foreign countries to run pre-paid systems for various goods and services (primarily pre-paid wireless at this point). In return, Vendtek receives a per-transaction fee every time someone buys, for example, pre-paid wireless time on a system that uses Vendtek's software.

One of the many great things about Vendtek is that, despite all of their success and rapid growth, it remains a cheap stock: on a \$38mm market cap (stock is at \$0.85), they should be reporting about \$90mm in profitable revenue for the FY ended October 31 2007; in FYE October 31 2008, they should do somewhere between \$120mm and \$150mm in revenue, and earnings of \$0.09/share are very achievable. The fact that the CEO bought shares in the open market during August at \$0.85 gives one an extra degree of comfort.

Aeromechanical also had a "breakthrough year" in 2007, signing 17 new airline customers (representing 508 new contracted aircraft), versus four customer signings in 2006 (representing 88 contracted aircraft). Aeromechanical also made significant inroads with OEMs, as I discovered when I attended the National Business Aviation Association annual conference in Atlanta last fall. I still maintain that they have one of the best business models I have ever come across:

- 1) They get monthly recurring revenue from equipment installed on aircraft, which are assets with operating lives of ten to thirty years, meaning that Aeromechanical has unprecedented annuity cash flow visibility, allowing significant multiples on revenues and cash-flow (akin to Absolute Software).
- 2) Their clients' ROI is one of the strongest I have ever seen: according to one client airline I spoke with, the cost savings generated by Aeromechanical's system resulted in only nine months to breakeven, and the airline is expecting a 14:1 ROI over ten years.

- 3) The regulatory barriers in the business of getting equipment installed on airplanes are huge, yet Aeromechanical has cleared enough of them that they have 685 contracted aircraft with 26 airlines, with a pipeline of qualified opportunities that could see them at 2000 contracted aircraft within 2-3 years. Once 2000 aircraft are installed, the company indicated on a recent conference call that revenues should be in the \$75 million range, with \$0.75/share in EBITDA.

So what might 2008 bring for Aeromechanical? Installations in China and an OEM win will be “breakthrough” milestones beyond the accelerating wins they are seeing in their traditional direct-to-airline sales. One million shares of insider buying in December is simply icing on the cake.

Webtech Wireless

What a year for Webtech. In the words of Charles Dickens: “It was the best of times, it was the worst of times.” The stock started the year at \$5.67, went briefly above \$7 in April, then plummeted in May, later going as low as \$2.00 in the August market panic, before recovering slightly to end the year at \$2.98, for a 47.4% fall. Despite the battering Webtech’s reputation has taken in the financial markets from the unraveling of their relationship with Volkswagen Brazil, this experience actually proved to be an enormous positive for the company within the automotive industry because Webtech proved that they could do something that few telematics providers have done: install two-way wireless portals into consumer automobiles on an assembly line moving at full capacity. Indeed, a number of important discussions they are now having on the consumer automotive side have resulted directly from *industry* reputation they gained through the technical success they experienced on the VW Brazil assembly line.

In the commercial and government fleet telematics side of their business, there were a number of notable wins, but the win that the market is waiting for (Fedex) has so far not materialized. Here are a few reasons from the mosaic of my due diligence that lead me to conclude that the Fedex win is imminent:

- 1) Webtech has posted a job opening on their web-site for a “Program Manager, Memphis Tennessee”. Memphis is, of course, the headquarters for Fedex, and, as I wrote in the last letter, I don’t believe Webtech would be trying to hire a program manager if there wasn’t a program to manage.
- 2) I spoke with my Fedex contact just after the December 20, 2007 Fedex conference call in which Fedex had announced a cut in capex. (Clearly, I was sweating a little at this news.) I had left my Fedex contact alone since the summer (at his request), so I wasn’t sure how the call would go. Although he said little, he did say that the IBM-WEW project has tested to be amongst the highest ROI IT projects that Fedex has ever examined, with a 1-year payback from cost savings when oil is \$70. In his opinion (and it is not his decision), it would be irrational *not* to go with the program. I was relieved to hear all of this, because on the conference call I had just listened to, the CFO had said during a portion of the Q+A (this is directly from the transcript): “Across the board, we are retargeting our priorities and have focused even more on what we think are the *very highest return projects* (my emphasis), setting others aside until we see a better economic environment.”

The whole process has taken longer than expected and Fedex has cut capex, so no one but a handful of people believes it is still coming. One thing is for sure: if (when?) the win is announced, it will absolutely stun the market, and it will be especially impressive that Fedex is willing to proceed with the project in this economic environment. The bears on this stock are numerous (short interest remains very high, at over 1 million shares), so the potential for a strong short squeeze is high, especially because—according to my IBM contact—the Fedex win will be a catalyst for many other wins to be consummated in short order. Bottom-line is that a Fedex win should be the catalyst for a strong 2008 for Webtech, and a series of years in which they can grow their revenue at an annualized rate of over 100%.

SXC Health Solutions (formerly Systems Xcellence)

SXC started 2007 at \$23.44, and I thought it would end the year somewhere between \$30 and \$40. A profit warning, however, caused by some clients who were not ready to begin system installations when originally scheduled, followed by the reversal of the biggest contract win in the history of the company because of a clerical error,² caused the stock to fall as low as \$11.08 in November before rebounding a bit to end the year at \$14.56 (for a decline of 37.9% on the year.)

This is a situation where I believe that the “core investment hypothesis” has remained intact despite these non-fundamental stumbles; I look forward to re-testing the hypothesis at a PBM sales conference next month. To me, it appears that SXC’s stock is well on the mend (as it was coming out of 2004 after a bout of weakness), with fundamental developments already starting to move in the right direction again. While waiting for that reassessment, we have a 4% position in the Innovation Fund (down from 12% on July 31st simply because of price depreciation), and have used the weakness to establish a 3% position in the Evolution Fund which was launched on August 27th.

Neptune Technologies and Bioresources

Neptune’s stock had a quiet year—that is, if you only look at where it started (\$4.39) and where it ended (\$4.54) for a 3.4% gain on the year. In between, however, the stock saw \$8 briefly in April, and \$2.81 at the height of the August panic. In contrast to Webtech and SXC, each of which ran into problems which allowed one to understand the dramatic stock weakness, I have a more difficult time understanding why Neptune’s stock was flat during a year when the fundamentals improved so dramatically! A few of the remarkable Neptune-specific developments during 2007 and early 2008 include:

- 1) a research and development deal with Nestle to develop a food ingredient that can be used in a wide variety of applications,
- 2) a development deal with Yoplait to develop dairy products containing modified NKO,

² The State of Georgia had posted on its semi-public web-site that it had awarded a very large claims processing contract to SXC. The win was subsequently rescinded because in the RFP document someone had checked the incorrect box on a question about capital structure and capital raising. A competitor had protested the award to SXC on this basis, and the protest was upheld, meaning that SXC’s win was un-done. The contract will be up for bid again sometime in 2008.

- 3) Dr. Stephen Nissen joined Neptune's Scientific Advisory Board. Bringing the Chairman of the Cleveland Clinic's Department of Cardiovascular Medicine on is no small achievement, particularly when he has played a key role in trials for many other cardio drugs, including Pfizer's HDL-boosting drug candidate, Torcetrapib,
- 4) a U.S. distribution deal with a well-established player in the health and nutraceutical market for a 300 mg version of their current nutraceutical product. The initial distribution is to occur across 365 Costco stores in the U.S. starting in January, 2008,
- 5) an exclusive distribution agreement for Australia and New Zealand, and a non-exclusive distribution agreement in Southeast Asia and Hong Kong. Product launches are scheduled to occur in February.

The two most powerful pharmaceutical industry developments which point to the value I believe the company will create in their pharma efforts are:

- 1) In January of 2007, Abbott closed on the \$3.7 billion acquisition of KOS Pharmaceuticals, mostly to obtain KOS' HDL-enhancing treatment "Niaspan", which is derived from Niacin. The significance of this acquisition is that it demonstrated that pharmaceutical companies can be willing to acquire products derived from naturally occurring substances; the fact that Neptune's NKO is derived from a natural substance was often cited by skeptics as a reason not to invest in Neptune.
- 2) In November of 2007, GSK bought Reliant Pharmaceuticals for US\$1.65 billion. The significance of this is that the drug that Reliant markets in the U.S. and Puerto Rico is the only prescription LDL (bad cholesterol) treatment that is derived from fish oil. The obvious follow-on significance here is twofold:
 - i. if a legitimate drug can be developed from fish oil, there is no reason that a legitimate drug can not be developed from krill oil;
 - ii. if a big pharma will pay \$1.65 billion for an LDL-only treatment derived from fish oil, there is no reason that big pharma won't pay similar amounts (and perhaps more) for an HDL/LDL drug that is derived from krill oil. The judgment that is required is how far along the path is Neptune to getting that value: the path has been blazed first by KOS, and now even more clearly by Reliant, removing much of the uncertainty about whether Neptune can accomplish their goals in the pharmaceutical space.

The puzzling thing is that at the beginning of 2007 when the stock was at \$4.39, none of these company or industry developments had yet occurred; by the end, they all (of course) had, yet the stock was only 3.4% higher. This is despite the fact that each development (both company-specific developments *and* the industry developments) have lent more and more credibility to the sum-of-the-parts models that I and two analysts maintain, giving a value to NTB of between \$16 and \$35/share, depending on the success achieved in each of the three parts.

Western Goldfields

Western Goldfields had a great year on all levels: the stock was up 35.6% during 2007 (even after being clubbed down to \$1.73 in the August panic, it still closed the year at \$3.81); management met all of their commitments regarding going into production (and in fact made the almost unheard of accomplishment of going into production three months earlier than their initial commitment); and even the hoped-for revaluation from a pre-production NAV multiple to a producer's NAV multiple moved in the right direction during the year. Having said that, I believe the revaluation still has quite a way to go, and with gold above \$800, that revaluation should take the stock into the \$5-\$7 range during 2008, assuming gold stays above \$750. With those bright prospects, Western Goldfields too is expected to continue to be a core position, as it has been since Randall Oliphant (the former CEO of Barrick) joined the company as Executive Chairman in December 2005.

In the case of *all* companies discussed above, I believe the “core investment hypothesis” (encompassing the company's sustainable competitive advantage and the hypothesis around why this company should experience secular growth for 5-10 years) is intact, and in most cases was strengthened during the year. At worst, the hypothesis was simply intact, despite short-term fumbles such as with SXC or WEW. Indeed, I will repeat again something I wrote in the last letter: the uncertainty and fear in the general markets is in stark contrast to the remarkably positive developments in a large number of our portfolio stocks, including recent insider buying at Webtech, Qustream, Vendtek, Aeromechanical, Ipico and Gastem.

Next closing

The next closing for the Northern Rivers Innovation RSP Fund, the Northern Rivers Conservative Growth Fund LP and the Northern Rivers Global Energy Fund LP is Thursday, January 31, 2008. As always, my colleagues and I will make ourselves available for meetings with interested parties. Please contact Robyn Graham, Vice President Sales & Marketing or Jeffrey Zicherman, Sales Associate for more information or to set up an appointment, or call 416-597-1226 to speak with any one of us concerning the specific funds we manage.

Best regards,



Hugh Cleland, CFA
Portfolio Manager

*Notes: Commissions, trailing commissions, management fees, performance fees and expenses all may be associated with investment funds. Please read the offering memorandum before investing. The average annual returns are the simple rates of return (1 month, 3 month, 6 months, and 1 year) or the historical annual compounded total returns (3 yrs, 5 yrs, and since inception). The annual returns are the historical annual simple returns for the 1-year periods ending December 31st or the simple returns YTD. All returns are net of fees. Rates of return shown do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Investment funds are not guaranteed, their values change frequently and past performance may not be repeated.