

CANADA
PROVINCE OF QUEBEC
DISTRICT OF MONTREAL
No.: 500-11-033234-085

**SUPERIOR COURT
Commercial Division
(Bankruptcy and Insolvency)**

**IN THE MATTER OF *THE COMPANIES' CREDITORS
ARRANGEMENT ACT*, R.S.C. (1985), c. C-36 WITH
RESPECT TO:**

SHERMAG INC., a legal person constituted under the Companies Act (Québec), having its domicile at 2171 King Street West, in the City of Sherbrooke and District of Saint-François, Province of Québec, J1J 2G1

- and -

JAYMAR FURNITURE CORP., a legal person constituted under the laws of Nova Scotia and continued under the laws of Canada, having its domicile at 75 Jaymar Street, in the City and District of Terrebonne, Province of Québec, J6W 1M5

- and -

SCIERIE MONTAUBAN INC., a legal person constituted under the laws of Canada, having its domicile at 100 Route du Lac George, in the City of Notre-Dame-de-Montauban and District of Saint-Maurice, Province of Québec, G0X 1W0

- and -

MÉGABOIS (1989) INC., a legal person constituted under the Companies Act (Québec), having its domicile at 2171 King Street West, in the City of Sherbrooke and District of Saint-François, Province of Québec, J1J 2G1

- and -

SHERMAG CORPORATION, a legal person constituted under the laws of the State of Delaware, having its chief executive office at Corporation Trust Center, 1209 Orange Street, in the City of Wilmington, State of Delaware, 19801, U.S.A.

-and-

JAYMAR SALES CORPORATION, a legal person constituted under the laws of the State of Nevada, having its chief executive office at Incorp Services, Inc., 3155 East Patrick Lane, Suite 1, in the City of Las Vegas, State of Nevada, 89120-3481, U.S.A.

Debtors/Petitioners

-and-

RSM RICHTER INC., a duly incorporated legal person having its principal place of business at 2 Place Alexis-Nihon, in the city and district of Montreal, H3Z 3C2

Monitor

**THIRD REPORT OF THE MONITOR
(SEPTEMBER 4, 2008)**

INTRODUCTION

1. On May 5, 2008, Shermag Inc. and its affiliates (hereinafter referred to as "Petitioners" or "Shermag") filed a Motion before the Quebec Superior Court asking for the issuance of an Initial Order in accordance with the provisions of the *Companies' Creditors Arrangement Act*, R.S.C. (1985), c. 36 ("CCAA"). In this regard, the Honourable Robert Mongeon, J.S.C., rendered the order in question and designated RSM Richter Inc. as Monitor ("RSM" or "Monitor") and a Stay Termination Date of June 4, 2008.
2. On June 4, 2008, Shermag was granted an extension of the delay for filing a Plan of Arrangement, extending the stay of proceedings, as provided for in the Initial Order, until September 8, 2008.
3. On July 16, 2008, Petitioners filed a Petition to establish a Claims and Meetings Process ("Claims Process") which was granted by the Court. The Claims Process set the bar date for filing of Proof of Claims or a Notice of Dispute with the Monitor by September 5, 2008 at 5:00 p.m.
4. On July 30, 2008, Shermag filed a Motion for an Order Approving Various Agreements, regarding its financing, which was granted by the Court.
5. On September 8, 2008, Shermag will present a Second Motion to Court for an Order extending the stay period, until December 10, 2008, and other requested relief.

6. This is the third report of RSM, the Designated Monitor in the Petitioners CCAA proceedings.
7. The purpose of this third report of the Monitor is to inform this Honourable Court on the following:
 - A. Business overview since the commencement of proceedings;
 - B. Efforts to liquidate surplus assets (inventory, equipment and facilities);
 - C. Commencement of Restructuring Efforts;
 - D. Cash-flow projections of Petitioners;
 - E. Extension of the forbearance agreement;
 - F. Actions taken by the Monitor;
 - G. Monitor's recommendations.
8. The Court should be aware that the information contained herein has not been the subject of a formal audit by us and comes from the unaudited books and records of the Petitioners made available to the Monitor and from conversations with the managers of the Company. RSM has not audited, reviewed or otherwise attempted to verify the accuracy and completeness of the information and, accordingly, RSM expresses no opinion or other form of assurance on the information contained in this report.

A) BUSINESS OVERVIEW SINCE THE COMMENCEMENT OF PROCEEDINGS

9. Since the commencement of proceedings, Shermag has worked to stabilize its operations and to develop a long term business plan.
10. Management has focused its efforts during this initial period on communicating with its key customers and suppliers to explain its current situation and secure their cooperation for the future; to disposing of surplus assets and generate funds to support its ongoing operations; and to the development of a long term restructuring plan (which is not yet completed).

11. Since the commencement of the proceedings, management and the Monitor have been in frequent communication with the secured lender, Wachovia Capital Finance Corporation ("Wachovia") and subsequently with Geosam Investments Limited ("Geosam"), the latter having replaced Wachovia as the secured lender as authorized pursuant to an Order Approving Various Agreements rendered on July 30, 2008.
12. Shermag has continued its operations with relative "normality" since the initial filing. Sales for the first five (5) months of the current fiscal year approximate \$23 million.

B) EFFORTS TO LIQUIDATE SURPLUS ASSETS

13. Further to the rendering of the Initial Order, Shermag identified certain assets which would no longer be required following its restructuring. Assisted by the Monitor, the Company sought and received offers for the following groups of assets:

- i) **Inventory** – As early as May 28, 2008, Shermag had received four (4) offers from liquidators in Canada and the U.S. interested in entering into an "en bloc" purchase agreement for surplus inventory valued at \$16.9 millions (at its current wholesale price).

Meanwhile, the Company conducted, through a third party, a liquidation sale of part of its surplus inventory at its Montreal warehouse and entered into certain agreements to hold inventory liquidation sales throughout its existing customer base.

Shermag did not retain any of the above offers from liquidators and decided to conduct its own liquidation, seeking better results. In fact, as at the beginning of September 2008, Shermag is conducting its own liquidation clearance sale of its surplus inventory at its Montreal warehouse while other liquidations performed by third parties will take place elsewhere in Quebec and Ontario. Shermag will also offer special prices to selected customers so as to clear the surplus inventory. The foregoing is taking place under the control and volition of Shermag's management, however with the approval of the Monitor and its secured lender, Geosam. The Second Motion presented concurrently with this report, seeks Court approval of this process.

- ii) **Equipment** – The Company had received four (4) proposals to liquidate the surplus equipment in eleven (11) plant locations. Again, Shermag has decided to liquidate same using internal contacts and via a virtual auction rather than using the liquidators in Canada and the U.S. However, Petitioners reserve their option to use the services of liquidators eventually. This liquidation process is commencing September 2008. The Second Motion presented concurrently with this report, seeks Court approval of this process, with the approval of the Monitor and Geosam.
- iii) **Facilities** – Shermag has identified fourteen (14) facilities in Quebec and New-Brunswick, which will no longer be required in its future business plan. All of these facilities are presently listed for sale with real estate agents except one.

The premises located at Montauban was subject to an accepted offer to sell, however the purchase offer which was subject to the transfer of certain forest cutting rights, failed due to the refusal by the Government to transfer said cutting rights.

The premises located in St-Etienne was sold in June 2008 for net proceeds of \$347,000.

On August 26, 2008, the Petitioners received an offer to sell their head office located at 2171 King Street West, Sherbrooke, so as to allow a move to smaller premises and reduce “bank advances”. The Petitioners are seeking approval of the transaction by the Court in the Second Motion, with the approval of the Monitor and Geosam.

C) COMMENCEMENT OF RESTRUCTURING EFFORTS

14. On July, 2008, in accordance with the Petitioners' business plan, Petitioners have, *inter alia*, terminated:
- i) the lease agreements for the distribution center they operate at Lasalle and the show rooms they have at High Point (North Carolina) and Mississauga (Ontario);
 - ii) the employment agreements of more than (53) employees whose services were no longer required pursuant to the new business plan; and
 - iii) various license, service, consulting, and equipment lease agreements which are no longer necessary or useful to Petitioners.

15. As mentioned previously herein, on July 16, 2008, Petitioners filed a Petition to Establish a Claims and Meeting Process which was granted by this Court according to its conclusions, the whole as it appears from the Court Record. Said Petition provides, *inter alia*, that the bar date for the filing of a Proof of Claim or a Notice of Dispute (as defined in the Claims Process) with the Monitor was September 5, 2008, at 5:00 p.m.
16. Petitioners, in collaboration with the Monitor and their advisors, are currently in the process of reviewing the various Proof of Claims and Notices of Dispute received to date. This process will help to assess the nature and amount to be offered to the creditors upon the filing of a Plan.

D) CASH FLOW PROJECTIONS OF PETITIONERS

i) Financial Results

17. Attached hereto as Schedule A to our report is the comparative cash flow statement for the period May 25, 2008 to August 31, 2008. The highlights of this statement are the following:
 - Total Bank indebtedness (amounts owned to Geosam) is higher than projected by \$1,582,000 (\$14,113,000 actual compared to a budget of \$12,532,000). This is mainly the result of the postponement of the machinery and equipment liquidation (\$2,366,000);
 - Net operating cash flows generated a surplus of \$1,258,000;
 - The inventory liquidation sales have exceeded the projections by \$118,000;
 - As a result of higher sales, the inventory purchases have exceeded the projections by \$270,000 for the period.
18. Other than post-filing payables, we are unaware of any material unpaid or incurred expense out of the ordinary course of business (aside from timing differences noted above) during this initial period following the commencement of proceedings and no allowance has been made in this regard.

ii) Financial Projections September 1, 2008 to January 3, 2009

19. Attached hereto as Schedule B to our report is the projected cash flow statement for the period September 1, 2008 to January 3, 2009 ("Period").

20. The Monitor assisted management of Shermag in the preparation of this cash flow which utilized unaudited financial information, management's projections relating to future events and management's assumptions with respect to results of operations during the forecast Period.
21. The projected cash flow reflects the following:
- i) Net Cash flow from operations should amount to a deficit of approximately \$2.9 million prior to consideration of other receipts from sales of redundant assets, restructuring costs and debt servicing;
 - ii) Management expects to generate approximately \$9.8 million during the Period relating to the sale of surplus equipment, the liquidation of already identified non-core surplus inventory and the sale of the head office;
 - iii) The cash flow assumes anticipated payments for restructuring professionals;
 - iv) Projected indebtedness to Geosam is expected to decrease by \$5.0 million during the Period, to \$9.1 million.
22. The projected cash flow attached hereto was compiled by the officers of the Petitioners and is based on economic assumptions which appear reasonable based on the limited review performed thereon. However, as these projections depend on future events, which are beyond the control of the parties involved, the actual results will differ and such differences may be substantial.

E) EXTENSION OF FORBEARANCE AGREEMENT

23. As a result of the order granted on July 30, 2008, approving various agreements, Geosam had entered into an assignment agreement with Wachovia, the former secured lender. Therefore, Geosam had amended the previous forbearance agreement as follows:
- Extension of the forbearance period to September 10, 2008;
 - Maximum credit is reduced to \$15 million;
 - Interest rate is set at 12% per annum;
 - No monitoring is required by the Monitor on behalf of Geosam.

24. It is anticipated that the forbearance agreement will be further extended and the secured lender will regularly review the financial results and performance of Shermag.

F) ACTIONS TAKEN BY THE MONITOR

25. On May 14, 2008, in accordance with the Initial Order, the Monitor sent to all the known creditors of Shermag a notice informing them of the issuance of the Initial Order and the stay of proceedings. The aforementioned notice advised creditors to regularly review the website of the Monitor for relevant information. A copy of the notice, along with a list of creditors, has been published on our website to ensure that all creditors have access to it. In addition, on May 30, 2008, the Monitor posted a notification of the Motion for an Order Extending the Stay Period and Other Requested Relief as well as the June 4, 2008 Extension Order along with the Second Monitor's Report.
26. On July 23, 2008, the Monitor mailed to all known creditors of Shermag, in accordance with the Claims Process Order, a Notice to Creditors of the Bar Date relating to the Filing of Claims. The Notice along with the Claims Process Order were posted on the Monitor's website.
27. Furthermore, the said Notice was published in the July 30, 2008 editions of the Globe and Mail (National Edition), La Presse as well as La Tribune (Sherbrooke).
28. The present report and associated Motion have been posted to the website of the Monitor prior to the hearing thereon.
29. The Monitor has assisted the management of Shermag in their initial meeting with employees and sales representatives as well as in meetings and communications with specific suppliers and the Company's lenders.
30. The Monitor has been kept informed of the Company's cash receipts and disbursements on a timely basis.
31. The Monitor has assisted management in its efforts to identify and dispose of surplus assets.
32. The Monitor is currently dealing with issues relating to the Claims Process and holding discussions with Petitioners and its legal counsel in the formulation of a Plan of Arrangement.

G) MONITOR'S RECOMMENDATIONS

33. The Motion presented by Shermag to grant a further delay until December 10, 2008 is reasonable and the Monitor supports the order sought for the following reasons:

- i) The delay requested is essential to allow Shermag to complete its restructuring initiatives and to formulate its Plan of Arrangement which will be in the best interests of all stakeholders;
- ii) The Company has continued to act diligently, in good faith and in the interest of all involved, including its creditors;
- iii) The Company's principal secured lender (Geosam) is in support of the restructuring efforts and of this Motion to Extend and for other relief;
- iv) To the best of our knowledge, as of the date hereof, no creditor has been adversely affected by the procedures instituted under the CCAA.

Dated at Montreal, this 4th day of September, 2008.

RSM Richter Inc.

Monitor designated by the Court

A handwritten signature in black ink, appearing to read 'P. Manel', with a large, sweeping underline that extends across the width of the signature.

Philip Manel, CA, CPA, CIRP

Shermag Inc. and Subsidiaries
Cash Flow Results
For the period May 25 to August 31, 2008

(In '000 \$ - Unaudited)

	Actual	Budget	Variance
RECEIPTS			
Cash Collections - Accounts Receivable	14,939	14,596	342
DISBURSEMENTS			
Payroll Expenditures (including benefits)	(3,510)	(3,804)	294
Inventory Disbursements - Raw Material	(2,107)	(1,783)	(324)
Inventory Disbursements - Finish Goods	(6,436)	(6,489)	54
	<u>(8,542)</u>	<u>(8,272)</u>	<u>(270)</u>
Operating Disbursements			
Production expenditures	(493)	(412)	(81)
Selling expenditures	(1,549)	(2,154)	605
General & Administrative expenditures	(462)	(676)	215
Insurance Payments	(35)	(140)	105
Sales Tax	(317)	(160)	(157)
Carrying costs - Assets for sale	-	(205)	205
	<u>(2,856)</u>	<u>(3,748)</u>	<u>892</u>
Total Operations Expenditures	(14,908)	(15,823)	915
Net Operations Cash Flow	31	(1,227)	1,258
Sale of Redundant Assets / Other Receipts			
Liquidation sales to the public	2,501	2,383	118
Real Estate Sales	347	345	2
Machinery & Equipment Sales	47	2,413	(2,366)
Income tax refund	-	500	(500)
	<u>2,895</u>	<u>5,641</u>	<u>(2,746)</u>
Restructuring Costs	(1,552)	(1,478)	(74)
Financing Expenditures			
Revolver and Term Debt Interest	(315)	(197)	(117)
Principle Amortization	(555)	(3,071)	2,515
Monitoring and other fees	24	(75)	99
	<u>(846)</u>	<u>(3,343)</u>	<u>2,496</u>
Net Cash Flow	527	(406)	934
Opening revolver	(7,507)	(7,507)	-
Closing Revolver	(6,980)	(7,913)	934
Opening term loan	(7,689)	(7,689)	-
Cash applied to term loan	555	3,071	(2,515)
Closing term loan	(7,134)	(4,618)	(2,515)
Closing total advances	(14,113)	(12,532)	(1,582)
Cumulative Incr. / (decr). of Indebtedness	(1,083)	(2,664)	1,582

SHERMAG Inn. And Subsidiaries**Cash Flow Projections****For the period September 1, 2008 to January 3, 2009**

(in '000\$ - Unaudited)

RECEIPTS

Cash Collections - Accounts Receivable 15,830

DISBURSEMENTS

Payroll Expenditures 4,415

Inventory purchases:

Raw Material 3,088

Finished Goods 7,045 10,133

Operating Disbursements:

Production expenditures 425

Selling expenditures 1,850

General & Administrative expenditures 848

Sales Tax 600

Carrying costs - Assets for sale 418 4,141

Total Operations Expenditures 18,689

Net Operations Cash Flow (2,859)

Sale of Redundant Assets / Other Receipts:

Liquidation sales (Lion du Meuble, Surplus RD and others) 6,850

Real Estate Sales 1,480

Machinery & Equipment Sales 1,500 9,830

Restructuring Costs (1,260)

Financing Expenditures

Revolver and Term Debt Interest - Geosam (657)

Principle Amortization - Geosam (2,980)

Monitoring and other fees - Geosam (90) (3,727)

Net Cash Flow 1,984**Total Indebtedness (9,149)**

Note: Detailed assumptions to the cash flow projections and the "weekly" skewing are available upon request.