

HARDWOODS DISTRIBUTION INCOME FUND



The Beauty of Hardwood

Second Quarter Report
To Unitholders
For the period ended
June 30, 2005

About the Fund

Hardwoods Distribution Income Fund (the “Fund”) is an unincorporated open-ended limited purpose trust. The Fund was launched on March 23, 2004 with the completion of an initial public offering (IPO) of 14.4 million trust units at \$10 per unit. Net proceeds of the IPO were used to acquire an 80% interest in a hardwoods lumber and sheet goods distribution business (“Hardwoods” or the “Business”).

Hardwoods Distribution Income Fund units trade on the Toronto Stock Exchange under the symbol HWD.UN. The Fund’s performance depends on the performance of the Business.

About the Business

Hardwoods has been providing quality lumber, hardwood plywood and specialty products to customers for over 45 years. Today, we are one of the largest distributors of hardwood lumber and sheet goods in North America, operating a network of 37 distribution centers organized into nine regional clusters.

With a proven track record of strong financial performance, Hardwoods plays a critical role linking suppliers and customers in a highly fragmented industry. The Business is diversified by geographic markets served, product mix, and customer type. Capital expenditure requirements are low and predictable, and Hardwoods has no significant supplier or customer concentration. Enjoying steady demand and stable pricing, Hardwoods is ideally suited to the income trust structure.



To Our Unitholders

I am pleased to present our results for the three and six month periods ended June 30, 2005. As the Fund commenced operations at the end of March 2004, there are no comparative figures provided in the attached unaudited interim consolidated financial statements for the six month period ended June 30, 2005. However, we have tried to enhance the usefulness of this report by making reference in certain circumstances to information that includes the results of the predecessor companies, adjusted on a pro forma basis to reflect the new financial structure of the Fund. In this light, we hope you find these references useful.

Cash Distributions

In the second quarter the Fund generated \$4.3 million of distributable cash available to unitholders, or \$0.30 per unit, and declared cash distributions to unitholders of \$3.9 million, or \$0.27. For the six months ended June 30, 2005 the Fund generated \$8.1 million of distributable cash available to unitholders, or \$0.56 per unit, and declared cash distributions to unitholders of \$7.8 million, or \$0.54 per unit. Considering these results, half way through the year the Fund remains on track to achieve the current annual rate of distributions of \$1.08 per unit. Since the Fund's inception the ratio of total cash distributions paid to unitholders as compared to cash available for distribution to unitholders is 88.5%.

Operating Results

As reported in our year end and first quarter report to unitholders, in 2005 we expected our operations to continue to perform well but at a more moderate pace of sales growth following the unusually strong sales increase achieved in 2004 of 14.3%. In particular, we anticipated sales would return to a historical rate of growth more in line with general inflation rates. With half of the year now complete, this outlook has proven to be the case. For the six months ended June 30, 2005, US dollar denominated sales are up 3.1% and Canadian dollar denominated sales are up 0.6%. Before considering the impact of changes in foreign exchange, these mid year numbers show that our US and Canadian businesses have consolidated the double digit sales gains made last year and are building on them in 2005, albeit at a moderate pace as predicted.

Impacting on these mid year sales results, however, are changes in the Canadian to US dollar exchange rate. We saw an 7.8% strengthening of the Canadian dollar in the first six months of the

year as compared to the first six months of 2004, which lowers the revenue contribution from our US operations when translated to Canadian dollars for financial reporting purposes. Approximately two-thirds of our sales are generated in the United States. Overall, on a year to date basis measured in Canadian dollars sales are \$176.9 million, a decrease of 3.2% as compared the first six months of 2004. This decrease is due entirely to the higher value of the Canadian dollar thus far in 2005.

So far this year our gross profit percentage has averaged 18.8%. This is a typical gross profit rate for our business, and is consistent with results we have achieved in the past two years. It is down slightly, however, from the 19.1% achieved in the comparative period in 2004 during a period of unusually strong product price escalation.

We are experiencing higher costs within the business in 2005, with year to date selling and administrative expenses at 11.9% of sales compared to 11.4% in the prior year. Much of this cost increase comes from adding new employees in order to position the Fund for the next level of sales growth within our existing distribution network as well as to staff planned new branch openings. In addition, the full cost impact of being a public entity is now embedded in our ongoing cost base, and some of these new costs had not yet been incurred at this time in the prior year. We continue to position our selling and administrative expenses to ensure they will be properly aligned to the expected future sales pace for the business.

Taking these factors all together, Hardwoods EBITDA and net earnings thus far in 2005 have not repeated the record profits achieved in the same time period in the prior year. A more moderate pace of sales growth, a stronger Canadian dollar, the return of gross profit percentage to a more historic level, and some necessary increases to the cost base combined to reduce net income to \$6.4 million from \$7.9 million in the six months ended June 30, 2005.

Outlook

Although mid year 2005 results are behind the record results achieved in the same time period in 2004, this performance is still very solid for our business. We remain on track to meet our current rate of distributions for the year. The economic climate looks favourable for the remainder of 2005, and we are experiencing steady demand for our products from our main customer groups of cabinet makers, custom millwork shops, and furniture manufacturers. Steps are also well underway to expand our business to achieve the next level of sales and profitability growth. Plans are in place to open a 40,000 square foot branch in Minneapolis, Minnesota and a 15,000 square

foot facility in Arthur, Illinois. Specific sites have been selected and operations are expected to commence in the third quarter. We have also recently more than doubled our warehouse capacity at our Elkhart, Indiana location to 42,000 square feet, and increased by 70% our warehouse in San Diego, California to 34,000 square feet. These increases will aid in additional sales penetration into those markets. These improvements in our distribution network provide the foundation for additional future sales growth, and require only modest upfront investment in expenses and capital expenditures that can be funded from existing cash flow. Sales gains from these facility additions and expansions are expected to take hold late in 2005 or early in 2006. We also continue to explore various acquisition opportunities within the fragmented hardwood distribution industry, and we believe there are transactions available that would be complementary to our business and be accretive to our unitholders.

I look forward to updating you on our progress following the completion of the third quarter.

Maurice E. Paquette

President and Chief Executive Officer



Management's Discussion and Analysis

July 29, 2005

This management's discussion and analysis ("MD&A") covers our unaudited interim consolidated financial statements for the three and six months ended June 30, 2005 ("Interim Financial Statements"). As well, it provides an update to the MD&A section contained in our 2004 annual report. The information below should be read in conjunction with the unaudited interim consolidated financial statements for the three and six month periods ended June 30, 2005 and the audited consolidated financial statements for the period from March 23, 2004 to December 31, 2004. Results are reported in Canadian dollars unless otherwise stated, and have been prepared in accordance with Canadian generally accepted accounting principles.

About the Fund

The Fund is an unincorporated open-ended limited purpose trust formed under the laws of the Province of British Columbia by a declaration of trust dated January 30, 2004. The Fund was launched on March 23, 2004 with the completion of an initial public offering ("IPO") of 14,410,000 trust Voting Units ("Units"). Net IPO proceeds of \$133.5 million, together with drawings on credit facilities totaling \$31.6 million, were used to acquire an 80% interest in the hardwood lumber and sheet goods distribution business ("Hardwoods" or the "Business") from the previous owners.

The owners of the predecessor companies have retained a 20% interest in the Business in the form of Special Voting Units of the Fund and Class B Limited Partnership units of the Fund's operating subsidiaries, which together are exchangeable into Units provided that the Fund achieves certain objectives. Distributions by the operating subsidiaries to the previous owners are subject to subordination arrangements until at least March 31, 2006. As at June 30, 2005, the following units of the Fund were issued and outstanding:

Units	14,410,000
Special Voting Units	3,602,500

Hardwoods Distribution Income Fund units trade on the Toronto Stock Exchange under the symbol HWD.UN. The Fund's performance depends on the performance of the Business.

Results of Operations

The Fund commenced operations on March 23, 2004. As such, no prior year comparative information is provided in the Interim Financial Statements for the six month period ended June 30th. In order to enhance the usefulness of this MD&A, certain financial and operating results are compared to information that includes the unaudited pro forma results of the predecessor companies, reflecting the new financial structure of the Fund. This information is for reference purposes only, and is not intended to represent a comprehensive comparison of the consolidated financial results or what the results would have been if the Fund had been created and operational at January 1, 2004. The comparative information for the three month period ended June 30, 2004 is also for a longer calendar reporting period, but represents substantially the same sales period in terms of days of business operation for the three months ended June 30, 2005, and consequently this difference does not materially impact the discussions below.

Non-GAAP Measures – EBITDA and Distributable Cash

References to “EBITDA” are to earnings before interest, income taxes, depreciation and amortization, mark-to-market gains or losses on foreign currency contracts and the non-controlling interest in earnings. Management believes that, in addition to net income or loss, EBITDA is a useful supplemental measure of performance and cash available for distribution prior to debt service, changes in working capital, capital expenditures and income taxes. Specifically, Management believes that EBITDA is the appropriate measure from which to make adjustments to determine the Distributable Cash available to unitholders of the Fund.

EBITDA is not an earnings measure recognized by generally accepted accounting principles in Canada (“GAAP”) and does not have a standardized meaning prescribed by GAAP. Investors are cautioned that EBITDA should not replace net income or loss (as determined in accordance with GAAP) as an indicator of our performance, or to cash flows from operating, investing and financing activities or as a measure of our liquidity and cash flows. Our method of calculating EBITDA may differ from the methods used by other issuers. Therefore, our EBITDA may not be comparable to similar measures presented by other issuers.

Distributable Cash available to unitholders of the Fund is a non-GAAP measure generally used by Canadian open-ended income funds as an indicator of financial performance. We define Distributable Cash available to unitholders as net earnings before depreciation, amortization, future income taxes, non-controlling interest and mark-to-market gains or losses on foreign exchange

contracts, and after capital expenditures, distributable cash available to non-controlling interest and contributions to any reserves that the Board of Trustees deem to be reasonable and necessary for the operation of the Fund.

Our Distributable Cash available to unitholders may differ from similar computations as reported by other similar entities and, accordingly, may not be comparable to distributable cash as reported by such entities. We believe that our Distributable Cash available to unitholders is a useful supplemental measure that may assist prospective investors in assessing the return on their investment in Units.

Results of Operations for the three month period ended June 30, 2005 and the period of March 23, 2004 to June 30, 2004

Selected Unaudited Consolidated Financial Information (in thousands of dollars)

	For the three months Ended June 30, 2005	For the period from March 23, 2004 to June 30, 2004 ⁽¹⁾
Total sales	\$ 91,852	\$ 99,125
<i>Sales in the US</i>	US\$ 49,577	US\$ 50,412
<i>Sales in Canada</i>	30,223	30,640
Gross profit	17,413	18,947
<i>Gross margin %</i>	19.0%	19.1%
Selling and administrative expenses	10,722	10,583
Net earnings for the period	3,442	4,684
Add :		
Income taxes	747	1,046
Interest	478	280
Amortization	567	618
Mark-to-market loss on foreign currency contracts	410	303
Non-controlling interest	<u>1,047</u>	<u>1,433</u>
Earnings before interest, taxes, depreciation and amortization and non-controlling interest ("EBITDA")	\$ 6,691	\$ 8,364
Deduct:		
Interest	(478)	(280)
Capital expenditures	(226)	(278)
Distributable Cash available to non-controlling interest ⁽²⁾	(1,197)	(1,561)
Current income taxes	<u>(473)</u>	<u>(726)</u>
Distributable Cash available to Unitholders	<u>\$ 4,317</u>	<u>\$ 5,519</u>
Cash distributions to Unitholders	\$ 3,890	\$ 4,020
Total assets	\$ 213,431	\$ 228,659
Foreign currency contracts - fair value	\$ 1,829	\$ (303)
Per Unit information:		
Basic and fully diluted earnings per Unit	\$ 0.239	\$ 0.325
Distributable Cash available to Unitholders per unit	\$ 0.300	\$ 0.383
Cash distributions per Unit	\$ 0.270	\$ 0.279
Average Canadian dollar/US dollar exchange rate	1.2431	1.3585

¹ This comparative information was the first period of operations of the Fund. This comparative information is for a longer calendar reporting period, but represents substantially the same sales period in terms of business operation compared to the three month period ended June 30, 2005. Consequently, this difference does not materially impact comparisons between the June 30, 2004 and 2005 periods.

² The non-controlling interest will be distributed to the previous owners who continue to own a 20% interest in the business of the Fund only to the extent the terms of the subordination agreement between the Fund and the previous owners are satisfied.

Sales

Sales for the three month period ended June 30, 2005 were \$91.9 million, down 7.3% from \$99.1 million in the comparative period from March 23, 2004 to June 30, 2004. Of this 7.3% decrease in total sales, 1.6% is due to lower underlying sales activity within the business and the rest is due to foreign exchange. Hardwoods' sales in the United States as measured in US dollars decreased by 1.7% and sales in Canada as measured in Canadian dollars decreased by 1.4%. Although sales did not grow incrementally during the second quarter, demand for our hardwoods products remained strong. Results achieved in the second quarter of 2004 represented 16% sales growth and record sales activity for Hardwoods at that time. The substantial sales gains realized in the second quarter of last year were largely sustained, but not increased upon, in the three months ended June 30, 2005. No new operating locations were opened during this period. An additional two branches are scheduled to open in the upcoming third quarter as discussed in the Outlook section on page 16 of this report.

The remaining 5.7% decrease in sales is due entirely to the impact of a strengthening Canadian dollar relative to the US dollar during the second quarter compared to the prior year. Approximately two-thirds of our sales are generated in the United States in US dollars. Accordingly, a higher Canadian dollar has a negative top line impact when we translate US sales to Canadian dollars for reporting purposes. The bottom line impact is significantly less, however, due to our use of foreign exchange contracts. Our use of foreign exchange contracts is described under Financial Instruments on page 16 of this report. Had exchange rates remained consistent with 2004 levels, revenue for the second quarter of 2005 would have been \$5.7 million higher, at \$97.6 million.

Gross Profit

Gross profit for the second quarter of 2005 was \$17.4 million. This was 8.1% less than the gross profit of \$18.9 million achieved in the comparative period from the prior year. Lower gross profit is due primarily to the 7.3% decrease in sales described above, combined with a slight decrease in gross margin percentage to 19.0% in 2005, compared to 19.1% in the 2004 period.

Selling and Administrative Expenses

For the three month period ended June 30, 2005 selling and administrative expenses were \$10.7 million, up \$0.1 million from \$10.6 million in the comparative period from March 23, 2004 to

June 30, 2004. The main increases relate to additional people costs and public entity expenses. Additional employees were hired to consolidate sales gains achieved in the prior year, and to provide support for planned new branch openings. Incremental public entity costs were also incurred in the second quarter of 2005 that had not arisen in the second quarter of 2004, which was the Fund's first quarter as a public entity. Partially offsetting these increases in selling and administrative costs were lower bad debt expenses in the quarter, as well as the strengthening value of the Canadian dollar which reduced the impact of US dollar expenses when translated to Canadian dollars for financial reporting purposes. As a percentage of sales, selling and administrative expenses were 11.7% of sales compared to 10.7% in the comparative period in the prior year.

Other Income

The mark-to-market valuation of our outstanding foreign currency contracts resulted in a loss of \$0.4 million in the second quarter. As of June 30, 2005 our foreign currency contracts continued to be an asset to the Fund, having a fair value of \$1.8 million. We continue to monitor our foreign currency contract policy to mitigate the impact of foreign exchange fluctuations on Canadian dollar distributions generated by our U.S. operations. Further discussion of our foreign currency contracts can be found under Financial Instruments on page 16 of this report.

EBITDA

EBITDA for the quarter was \$6.7 million compared to \$8.4 million in the comparative period from March 23, 2004 to June 30, 2004. This \$1.7 million decrease in EBITDA is primarily due to a \$1.5 million reduction in gross profit dollars as a consequence of lower sales and a slightly reduced gross margin percentage, combined with a \$0.1 million increase in selling and administrative expenses.

Net Earnings

Net earnings for the three months ended June 30, 2005 were \$3.4 million, compared to \$4.7 million in the comparative period in 2004. The \$1.3 million decrease in net earnings primarily reflects the decrease in EBITDA, partially offset by lower income taxes and reduced non-controlling interest as a consequence of lower earnings in the quarter.

Results of Operations for the six month period ended June 30, 2005 and June 30, 2004

Selected Unaudited Consolidated Financial Information (in thousands of dollars)

	For the six months Ended June 30, <u>2005</u>	For the six months Ended June 30, <u>2004</u> ⁽¹⁾
Total sales	\$ 176,879	\$ 182,688
<i>Sales in the US</i>	US\$ 96,837	US\$ 93,889
<i>Sales in Canada</i>	57,247	56,905
Gross profit	33,232	34,917
<i>Gross margin %</i>	18.8%	19.1%
Selling and administrative expenses	21,033	20,897
Net earnings for the period	6,384	7,924
Add :		
Income taxes	1,185	1,546
Interest	905	680
Amortization	1,150	1,199
Mark-to-market loss on foreign currency contracts	683	303
Non-controlling interest	<u>1,892</u>	<u>2,368</u>
Earnings before interest, taxes, depreciation and amortization and non-controlling interest ("EBITDA")	\$ 12,199	<u>\$ 14,020</u>
Deduct:		
Interest	(905)	
Capital expenditures	(455)	
Distributable Cash available to non-controlling interest ⁽²⁾	(2,168)	
Current income taxes	<u>(598)</u>	
Distributable Cash available to Unitholders	<u>\$ 8,073</u>	
Cash distributions to Unitholders	\$ 7,781	
Total assets	\$ 213,431	
Foreign currency contracts - fair value	\$ 1,829	
Per Unit information:		
Basic and fully diluted earnings per Unit	\$ 0.443	
Distributable Cash available to Unitholders per unit	\$ 0.560	
Cash distributions per Unit	\$ 0.540	
Average Canadian dollar/US dollar exchange rate	1.2354	1.3397

¹ Financial results for the period January 1, 2004 to March 22, 2004 are of predecessor companies and have been adjusted on a pro forma basis to reflect the Fund's capital structure and the acquisition of the Hardwoods Group of Companies by the Fund. Significant pro forma adjustments related to changes in amortization, interest, non-controlling interest and income tax expenses. The pro forma results of the predecessor companies from the period January 1, 2004 to March 22, 2004 have been compiled with the results of the Fund for the period March 23, 2004 to June 30, 2004.

² The non-controlling interest will be distributed to the previous owners who continue to own a 20% interest in the business of the Fund only to the extent the terms of the subordination agreement between the Fund and the previous owners are satisfied.

Sales

Hardwoods continues to enjoy steady demand for our hardwood lumber and sheet goods products. Half way through the year, Hardwoods' sales in the US as measured in US dollars have grown by 3.1%, and sales in Canada as measured in Canadian dollars have grown 0.6%. During this six

month period, however, the Canadian dollar exchange rate appreciated by 7.8% when compared to the same six month period in the prior year. When Canadian and US sales are taken together and translated to Canadian dollars for reporting purposes, this strengthening of the Canadian dollar fully eliminates the sales gains achieved by the underlying businesses and results in a net decrease in overall reported sales. Sales for the six month period ended June 30, 2005 were \$176.9 million, down 3.2% from \$182.7 million in the comparative period ended June 30, 2004 due entirely to foreign exchange. Had exchange rates remained consistent with 2004 levels, revenue for the first six months of the of 2005 would have been \$10.1 million higher, at \$187.0 million. Hardwoods seeks to minimize the impact of foreign exchange with the use of foreign exchange contracts. Our use of foreign exchange contracts is described under Financial Instruments on page 16 of this report.

Gross Profit

Gross profit for the six months ended June 30, 2005 was \$33.2 million, down \$1.7 million from \$34.9 million in the six months ended June 30, 2004. Lower sales accounted for \$1.2 million of this reduction in gross profit, and lower gross margin percentage accounted for the remaining \$0.5 million reduction. Gross margin percentage in the first half of the year was 18.8%. Historically, a gross margin of 18.8% is considered very solid performance for the Hardwoods' business, but it is less than the 19.1% achieved in the same period in 2004. The 19.1% gross margin percentage in the 2004 period was earned during a period of rising product prices that was unusually strong by historic standards.

Selling and Administrative Expenses

For the six month period ended June 30, 2005 selling and administrative expenses were \$21.0 million, up \$0.1 million from \$20.9 million in the six month period ended June 30, 2004. Selling and administrative costs are 11.9% of sales mid way through 2005, compared to 11.4% in the same period in 2004 reflecting the decrease in sales in the current six month period.

Other Income

The mark-to-market valuation of our outstanding foreign currency contracts resulted in a loss of \$0.7 million for the six months ended June 30, 2005, as a result of a stronger US dollar versus the Canadian dollar at June 30, 2005 as compared to at December 31, 2004. We continue to monitor our foreign currency contract policy to mitigate the impact of foreign exchange fluctuations on Canadian dollar distributions generated by our U.S. operations. The fair value of our foreign

currency contracts at June 30, 2005 is an asset of the Fund of \$1.8 million. Further discussion of our foreign currency contracts can be found under Financial Instruments on page 16 of this report.

EBITDA

EBITDA for the first six months of 2005 was \$12.2 million compared to \$14.0 million in the same period in 2004. This \$1.8 million decrease in EBITDA is primarily due to a \$1.7 million reduction in gross profit dollars as a consequence of lower sales and a slightly reduced gross margin percentage, combined with a \$0.1 million increase in selling and administrative expenses.

Net Earnings

Net earnings for the three months ended June 30, 2005 were \$6.4 million, compared to \$7.9 million in the comparative period in 2004. The \$1.5 million decrease in net earnings primarily reflects the decrease in EBITDA, combined with a higher mark-to-market loss in valuation of outstanding foreign currency contracts, but partially offset by lower income taxes and reduced non-controlling interest as a consequence of lower earnings for the period.

Quarterly Financial Information

The table below provides selected quarterly financial information for the five most recent fiscal quarters to June 30, 2005. This information is unaudited, but reflects all adjustments of a normal, recurring nature which are, in our opinion, necessary to present a fair statement of the results of operations for the periods presented. Quarter-to-quarter comparisons of our financial results are not necessarily meaningful and should not be relied upon as indication of future performance. Historically, the first quarter and fourth quarter have been seasonally slower periods for the Business. In addition, net earnings reported in each quarter will be impacted by mark-to-market gains or losses on foreign currency contracts, which are described under Financial Instruments on page 16 of this report.

(in thousands of dollars)	For the three months ended June 30, <u>2005</u>	For the three months ended March 31, <u>2005</u>	For the three months ended December 31, <u>2004</u>	For the three months ended September 30, <u>2004</u>	For the Period March 23, 2004 to June 30, <u>2004</u>
Total sales	\$ 91,852	\$ 85,027	\$ 93,730	\$ 97,040	\$ 99,125
Net earnings	\$ 3,442	\$ 2,942	\$ 5,568	\$ 4,351	\$ 4,684
Basic and fully diluted earnings per Unit	\$ 0.239	\$ 0.204	\$ 0.386	\$ 0.302	\$ 0.325
Distributable cash available per Unit	\$ 0.300	\$ 0.261	\$ 0.312	\$ 0.279	\$ 0.383
Cash distributions per Unit	\$ 0.270	\$ 0.270	\$ 0.270	\$ 0.270	\$ 0.279

Liquidity

Distributable Cash and Distributions

Our policy is to make stable monthly distributions to our unitholders based on our estimate of distributable cash for the year. We pay distributions at the end of the month that follows the month when the cash was earned. The Fund also makes quarterly distributions to Hardwoods' previous owners which are, on an after-tax per unit basis, equivalent to the respective quarterly distributions to public unitholders. Quarterly distributions to Hardwoods' previous owners are made pursuant to the terms of a subordination agreement as outlined in the Fund's Annual Information Form dated March 24, 2005.

For the period from the Fund's IPO on March 23, 2004 to June 30, 2005 the ratio of total cash distributions paid to unitholders as compared to cash available for distribution to unitholders was 88.5%. The income characterization of the distributions paid to unitholders in 2004 was approximately 56% fully taxable distribution, 22% dividends, and 22% return of capital. The approximate expectations for 2005 are 57% fully taxable, 24% dividends, and 19% return of capital.

Capital Expenditures

Maintenance capital expenditures were \$0.2 million for the three months ended June 30, 2005 and \$0.5 million for the six months of 2005. In the second quarter we sold and leased-back the only land and building owned by the Fund or any of its subsidiaries. Net cash proceeds of \$2.2 million were received and a gain on sale realized of \$0.9 million. In accordance with Canadian generally accepted accounting principles, the \$0.9 million gain has been treated as a deferred gain to be amortized in proportion to the rental payments over the term of the lease.

As we now lease all of our buildings, and we contract out all freight delivery services, our business has minimal capital requirements. Our capital expenditures are principally comprised of replacement of forklifts, furniture and fixtures, leasehold improvements, and computer equipment. We estimate our maintenance capital expenditures will be approximately \$1 million annually. Additional capital expenditures may be incurred for new branch openings or to support acquisition opportunities that arise.

Revolving Credit Facilities

We have independent credit facilities in each of Canada and the US. In Canada, the term of our three year operating line extends to March 23, 2007 and comprises a maximum facility of \$22.0

million. The balance outstanding on the Canadian operating line as at June 30, 2005 was \$12.4 million. In the US, the term of our three year operating line extends to March 31, 2007 and comprises a maximum facility of \$37.0 million (US \$30.0 million). As at March 31, 2005 the balance outstanding on the US operating line was \$26.0 million (US \$21.1 million). We believe that our operating lines in both Canada and the U.S. are sufficient to meet our working capital requirements.

Contractual Obligations

The table below sets forth other remaining contractual obligations of the Fund as at June 30, 2005 due in the years indicated, which relate to various premises operating leases:

<u>Total</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010 and thereafter</u>
\$28,779,595	\$3,380,883	\$5,754,906	\$5,544,025	\$5,116,924	\$4,146,585	\$4,836,272

The above contractual obligations include the rental payments required under the sale-leaseback transaction described under Capital Expenditures on page 14 of this report.

Off-Balance Sheet Arrangements

The Fund has no off balance sheet arrangements. The foreign currency contracts discussed under Financial Instruments on page 16 of this report are marked-to-market at the end of each quarter, with the fair value recorded on the balance sheet.

Critical Accounting Estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires that we make estimates and assumptions that can have a material impact on our results of operations as reported on a periodic basis. We base our estimates and assumptions on past experience and other factors that are deemed reasonable under the circumstances. Actual results could differ from these estimates. The critical estimates used in preparing our financial statements are:

Accounts Receivable Provision: Due to the nature of our business and the credit terms we provide to our customers, we anticipate that a certain portion of required customer payments will not be made, and we maintain an allowance for these doubtful accounts. The allowance is based on our estimation of the potential of recovering our accounts receivable and incorporates current and expected collection trends.

Valuation of Inventories: The net realizable value of our inventory could be affected by market shifts or damage to our products. Our inventory is valued at the lower of cost and net realizable value.

Related Party Transactions

Related parties refers to affiliates of the previous owners of the Business who have retained a 20% interest in Hardwoods through ownership of Class B Hardwoods LP units and Class B Hardwoods USLP units, respectively. For the three months ended June 30, 2005 sales of \$0.5 million were made to related parties, and the subsidiaries of the Fund purchased \$40,522 from related parties. For the six months ended June 30, 2005 sales of \$1.4 million were made to related parties, and the subsidiaries of the Fund purchased \$0.1 million from related parties. These sales and purchases took place at prevailing market prices. As at June 30, 2005, the Fund recorded a distribution payable to related parties of \$1.0 million pursuant to the terms of a subordination agreement as outlined in the Fund's Annual Information Form dated March 24, 2005. This distribution payable was paid on July 29, 2005. Subsidiaries of the Fund also paid \$25,704 in the second quarter and \$58,976 in the six months ended June 30, 2005 to related parties under the terms of an agreement to provide transitional services for management information systems.

Financial Instruments

The Fund uses currency derivatives to manage its exposure to fluctuations in exchange rates between the Canadian dollar and the United States dollar. The foreign currency contracts are recognized in the balance sheet and measured at their fair value, with changes in fair value recognized currently in the statement of operations. At June 30, 2005, the Fund had 34 monthly foreign currency contracts to exchange US\$675,000 into approximately \$878,000, reflecting an exchange rate of Cdn\$1.30 to US\$1.00, each month until April 2008. The fair value of the remaining 34 monthly contracts has been reflected in the financial statements. Based on the Fund's current monthly distribution of \$0.09 per unit, the principal value of the monthly foreign currency contracts is sufficient to fully cover the amount of US dollar earnings necessary to be converted to Canadian dollars in order to pay projected distributions to public unitholders.

Outlook

Half way through 2005, business results are on track to meet our current annual rate of distributions of \$1.08 per unit. As indicated in our previous outlook comments in the fourth quarter of 2004 and the first quarter of 2005, the business was expected to continue to grow in

2005, but at a more moderate rate of sales growth than was seen in the initial nine months following our IPO on March 23, 2004. This has proven to be the case, with 3.1% underlying sales growth in our US business (measured in US dollars) and 0.6% in our Canadian business in the first six months of the year. The negative impact of foreign exchange movements, however, has more than offset these sales gains and impacted our reported sales results. Looking ahead to the second half of the year, we expect our underlying businesses to retain the significant sales gains we achieved in 2004, and to continue to build on them at a moderate rate. Foreign exchange movements, however, may continue to impact upon the underlying sales growth when translated to Canadian dollars for reporting purposes.

In addition to moderate organic sales growth within our existing branch operations, steps are underway to increase future sales through new branch openings. Plans are in place to open a 40,000 square foot branch in Minneapolis, Minnesota and a 15,000 square foot facility in Arthur, Illinois. Specific sites have been selected and operations are expected to commence in the third quarter. We have also recently doubled our warehouse capacity at our Elkhart, Indiana and San Diego, California locations to aid in additional sales penetration into those markets. These improvements in our distribution network provide the foundation for additional future sales growth, and require only modest upfront investment in expenses and capital expenditures that can be funded from existing cash flow. Sales gains from these facility additions and expansions are expected to take hold late in 2005 or early in 2006. We also continue to explore various acquisition opportunities within the fragmented hardwood distribution industry, and believe there are transactions available that would be complementary to our business and be accretive to our unitholders.

Aside from implementing plans to grow the business geographically by opening new and expanding existing branches, we are focused in the second half of 2005 on managing gross margin and our selling and administrative costs. Emphasis will continue on disciplined selling practices to hold and improve upon our recent gross margin percentage results, which have averaged 18.6% in the five completed quarters since our IPO. Selling and administrative costs will also be closely managed in the second half to ensure that these expenses are properly matched to the expected future sales pace of the business.

In summary, the economic environment continues to be favourable for our business. Hardwoods has provided solid results thus far in 2005, and is expected to continue to do so through the year end. Plans for expansion to our branch network are being implemented that are expected to

provide additional growth for the business in the future. We look forward to updating you on our progress at the end of the third quarter.

Forward-looking Statements

This MD&A may contain forward-looking statements, which reflect our expectations regarding the future growth, results of operations, performance and business prospects, and opportunities of the Fund. Forward-looking statements contain such words as “anticipate”, “believe”, “continue”, “could”, “expects”, “intend”, “may”, “plans” or similar expressions suggesting future conditions or events. Such forward-looking statements reflect our current beliefs and are based on information currently available to us. Forward-looking statements involve significant risks and uncertainties. A number of factors could cause actual results to differ materially from results discussed in the forward-looking statements, including the effects of, as well as changes in: national and local business conditions; political or economic instability in local markets; competition; consumer preferences, spending patterns and demographic trends; legislation and governmental regulation. Although the forward-looking statements contained in this MD&A are based on what we believe to be reasonable assumptions, we cannot assure readers that actual results will be consistent with these forward-looking statements.

Additional Information

Additional information relating to the Fund, including all public filings, are available on SEDAR (www.sedar.com) and our website (www.hardwoods-inc.com).

HARDWOODS DISTRIBUTION INCOME FUND

Consolidated Balance Sheets
(Unaudited)
(Expressed in thousands of Canadian dollars)

	June 30, 2005	December 31, 2004
Assets		
Current assets:		
Accounts receivable	\$ 48,798	\$ 45,283
Income tax receivable	38	401
Inventory	43,662	42,499
Prepaid expenses	1,006	627
	<u>93,504</u>	<u>88,810</u>
Long-term receivables	2,030	1,787
Property, plant and equipment	3,335	4,687
Deferred financing costs	113	142
Other intangible assets	13,036	13,293
Foreign currency contracts (note 3)	1,829	2,511
Goodwill	99,584	98,283
	<u>\$ 213,431</u>	<u>\$ 209,513</u>
Liabilities and Unitholders' Equity		
Current liabilities:		
Bank indebtedness (note 4)	\$ 38,420	\$ 39,058
Accounts payable and accrued liabilities	10,082	7,897
Distributions payable to Unitholders	1,297	1,297
Distributions payable to non-controlling interests	1,040	981
	<u>50,839</u>	<u>49,233</u>
Future income taxes	1,132	545
Deferred gain on sale-leaseback of land and building	897	-
Non-controlling interests (note 5)	32,373	32,123
Unitholders' equity:		
Fund Units (Issued and outstanding 14,410,000 Units)	133,454	133,454
Retained earnings	1,404	2,801
Cumulative foreign currency translation account	(6,668)	(8,643)
	<u>128,190</u>	<u>127,612</u>
	<u>\$ 213,431</u>	<u>\$ 209,513</u>

See accompanying notes to consolidated financial statements.

Approved on behalf of the Trustees:

(Signed) LAWRENCE I. BELL Trustee

(Signed) TERRY M. HOLLAND Trustee

HARDWOODS DISTRIBUTION INCOME FUND

Consolidated Statements of Operations and Retained Earnings

(Unaudited)

(Expressed in thousands of Canadian dollars)

	Three month period ended June 30, 2005	Period from March 23, 2004 to June 30, 2004	Six month period ended June 30, 2005
Sales	\$ 91,852	\$ 99,125	\$ 176,879
Cost of sales	74,439	80,178	143,647
Gross profit	17,413	18,947	33,232
Expenses:			
Selling and administrative	10,722	10,583	21,033
Amortization:			
Plant and equipment	312	348	643
Deferred financing costs	16	17	32
Other intangible assets	239	253	475
Interest	478	280	905
Mark-to-market loss on foreign currency contracts (note 3)	410	303	683
	12,177	11,784	23,771
Earnings before non-controlling interests and income taxes	5,236	7,163	9,461
Non-controlling interests (note 5)	1,047	1,433	1,892
Earnings before income taxes	4,189	5,730	7,569
Income taxes	747	1,046	1,185
Net earnings for the period	3,442	4,684	6,384
Retained earnings, beginning of period	1,852	-	2,801
Distributions to Unitholders	(3,890)	(4,020)	(7,781)
Retained earnings, end of period	\$ 1,404	\$ 664	\$ 1,404
Basic and diluted earnings per Unit	\$ 0.24	\$ 0.33	\$ 0.44
Weighted average number of Units outstanding	14,410,000	14,410,000	14,410,000

See accompanying notes to consolidated financial statements.

HARDWOODS DISTRIBUTION INCOME FUND

Consolidated Statement of Cash Flows

(Unaudited)

(Expressed in thousands of Canadian dollars)

	Three month period ended June 30, 2005	Period from March 23, 2004 to June 30, 2004	Six month period ended June 30, 2005
Cash flows provided by (used in) operating activities:			
Net earnings for the period	\$ 3,442	\$ 4,684	\$ 6,384
Items not involving cash:			
Amortization	567	618	1,150
Gain on sale of property, plant and equipment	(41)	(18)	(45)
Mark-to-market loss on foreign currency contracts	410	303	683
Non-controlling interests	1,047	1,433	1,892
Future income taxes	274	320	587
	5,699	7,340	10,651
Change in non-cash operating working capital (note 6)	2,037	(12,720)	(1,117)
Net cash provided by (used in) operating activities	7,736	(5,380)	9,534
Cash flows provided by (used in) investing activities:			
Additions to property, plant and equipment	(226)	(278)	(455)
Proceeds on disposal of property, plant and equipment	2,186	30	2,190
Increase in long-term receivables, net	(415)	-	(209)
Business acquisition (note 1)	-	(165,137)	-
Net cash provided by (used in) investing activities	1,545	(165,385)	1,526
Cash flows provided by (used in) financing activities:			
Increase (decrease) in bank indebtedness	(4,372)	43,322	(1,274)
Distributions paid to Unitholders	(3,890)	(2,789)	(7,781)
Distributions paid to non-controlling interests	(1,019)	-	(2,005)
Net proceeds from the issuance of units	-	133,454	-
Increase in deferred financing fees	-	(204)	-
Net cash provided by (used in) financing activities	(9,281)	173,783	(11,060)
Increase in cash	-	3,018	-
Decrease in cash due to foreign currency fluctuations	-	(13)	-
Cash, beginning of period	-	-	-
Cash, end of period	\$ -	\$ 3,005	\$ -
Supplementary information (cash amounts):			
Interest paid	\$ 478	\$ 280	\$ 905
Income taxes paid	190	364	234

See accompanying notes to consolidated financial statements.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Consolidated Financial Statements

(Unaudited)

(Tabular amounts expressed in thousands of Canadian dollars)

1. Nature of operations and business acquisition:

Hardwoods Distribution Income Fund (the "Fund") is an unincorporated, open ended, limited purpose trust established under the laws of the Province of British Columbia on January 30, 2004 by a Declaration of Trust. The Fund commenced operations on March 23, 2004 when it completed an initial public offering (the "Offering") of Units and acquired (the "Acquisition") an 80% interest in a hardwood lumber and sheet goods distribution business in North America (the "Business") from affiliates of Sauder Industries Limited ("SIL"). The Fund holds, indirectly, 80% of the outstanding limited partnership units of Hardwoods Specialty Products LP ("Hardwoods LP") and Hardwoods Specialty Products US LP ("Hardwoods USLP"), limited partnerships established under the laws of the Province of Manitoba and the state of Delaware, respectively.

On March 23, 2004, the Fund issued 14,410,000 Units at \$10 per Unit pursuant to the Offering. Net proceeds from the Offering were \$133,454,000, after deducting expenses of the Offering of \$10,646,000.

Also on March 23, 2004, the Fund used the net proceeds from the Offering, together with funds from two new credit facilities (note 4), to acquire an 80% interest in Hardwoods LP and Hardwoods USLP for total consideration of approximately \$165,137,000. The acquisition of the Fund's interest in Hardwoods LP and Hardwoods USLP was completed through a series of transactions and has been accounted for using the purchase method.

The fair value of the net assets acquired was as follows:

Net working capital	\$ 73,658
Property, plant and equipment	5,094
Goodwill	104,580
Other intangible assets	15,000
Future income taxes	267
Non-controlling interests	(33,462)

Consideration, being cash from the Offering and new credit facilities	\$ 165,137
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The results of operations of Hardwoods LP and Hardwoods USLP have been included in the Fund's consolidated financial statements from March 23, 2004, being the date of acquisition. No comparative financial information has been provided for the six month period from January 30, 2004 to June 30, 2004, as the Fund was inactive prior to March 23, 2004, and the Fund's first quarterly report was as at June 30, 2004 and reflected the results of operations of the Fund for the period March 23, 2004, to June 30, 2004.

2. Basis of presentation:

The Fund prepares its interim consolidated financial statements in accordance with Canadian generally accepted accounting principles on a basis consistent with those used and described in the annual consolidated financial statements for the period ended December 31, 2004, except for the adoption of an accounting policy for sale-leaseback accounting as described below. The disclosures contained in these interim consolidated financial statements do not include all the requirements of Canadian generally accepted accounting principles for annual financial statements, and accordingly these interim consolidated financial statements should be read in conjunction with the annual consolidated financial statements as at and for the period ended December 31, 2004.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Consolidated Financial Statements

(Unaudited)

(Tabular amounts expressed in thousands of Canadian dollars)

2. Basis of presentation (continued):

During the three months ended June 30, 2005, the company sold a building and related land and leased back the facilities. The gain on the sale has been deferred and is amortized in proportion to the rental payments over the lease term. The lease commitment over the next five years is approximately \$1.2 million.

3. Foreign currency contracts:

In order to manage the Fund's exposure to exchange rate fluctuations on United States dollar denominated distributable cash, a subsidiary of the Fund has entered into foreign currency contracts to exchange US\$675,000 each month for approximately \$878,000 until April 2008, reflecting an exchange rate of \$1.30. The remaining 34 monthly foreign currency contracts at June 30, 2005 are recognized in the balance sheet and measured at fair value, which at June 30, 2005 represented an asset of \$1,829,000. Changes in fair value are recognized in earnings.

4. Bank indebtedness:

	June 30, 2005	December 31, 2004
Checks issued in excess of funds on deposit	\$ 8	\$ 1,186
Credit facility, Hardwoods LP	12,394	14,000
Credit facility, Hardwoods USLP (June 30, 2005-US\$21,110; December 31, 2004 - US\$19,860)	26,018	23,872
	\$ 38,420	\$ 39,058

5. Non-controlling interests:

Balance, January 1, 2005	\$ 32,123
Interest in earnings for the period	1,892
Distributions paid to non-controlling interests	(2005)
Change in distributions payable to non-controlling interests	(59)
Foreign currency translation adjustment of non-controlling interest in Hardwoods USLP and other	422
Balance, end of period	\$ 32,373

The previous owners of the Business (note 1) have retained a 20% interest in Hardwoods LP and Hardwoods USLP through ownership of Class B Hardwoods LP units ("Class B LP Units") and Class B Hardwoods USLP units ("Class B USLP Units"), respectively. The Fund owns an indirect 80% interest in Hardwoods LP and Hardwoods USLP through ownership of all Class A Hardwoods LP units ("Class A LP Units") and Class A Hardwoods USLP units ("Class A USLP Units"), respectively.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Consolidated Financial Statements

(Unaudited)

(Tabular amounts expressed in thousands of Canadian dollars)

5. Non-controlling interests (continued):

The Class A LP Units and Class B LP Units and the Class A USLP Units and Class B USLP Units, respectively, have economic and voting rights that are equivalent in all material respects except distributions on the Class B LP Units and Class B USLP Units are subject to the subordination arrangements described below until the date (the "Subordination End Date") on which:

- the consolidated Adjusted EBITDA, as defined in the Subordination Agreement dated March 23, 2004, of the Fund for the 12 month period ending on the last day of the month immediately preceding such date is at least \$21,300,000; and
- cash distributions of at least \$29,540,000 (\$2.05 per Unit) have been paid on the Units and a combined amount of cash advances or distributions of at least \$7,385,000 has been paid on the Class B LP Units and Class B USLP Units, being \$2.05 per combined Class B LP and Class B USLP Units (as adjusted for issuances, redemptions and repurchases of Units, LP Units and USLP Units subsequently and by converting the cash distributions or advances by Hardwoods USLP on the USLP Units at the rate of exchange used by the Fund to convert funds received by it in US dollars into Canadian dollars) for the 24 month period ending on the last day of the month immediately preceding such date.

The Subordination End Date had not occurred at June 30, 2005 and cannot occur before March 31, 2006.

Distributions are to be made monthly on the Class A LP Units and Class A USLP Units equal to at least \$0.0854 per Unit to the extent cash is available to make cash distributions and as determined by the board of directors of the general partners. Distributions on the Class B LP Units and Class B USLP Units will be subordinated and will be made quarterly in a combined amount for one Class B LP Unit and one Class B USLP Unit equal, on a pro rated basis, to the combined amount distributed on one Class A LP Unit and one Class A USLP Unit during such fiscal quarter, only after the distributions have been made on the Class A LP Units and Class A USLP Units and to the extent cash is available to make such distributions.

After the Subordination End Date, the holders of the Class B LP Units and Class B USLP Units will generally be entitled to effectively exchange all or a portion of their Class B LP Units and Class B USLP Units together for up to 3,602,500 Units of the Fund, representing 20% of the issued and outstanding Units of the Fund on a fully diluted basis. In the event the Fund enters into an agreement in respect of an acquisition or a take-over bid of the Fund, the holders of the Class B LP Units and Class B USLP Units will be entitled to exchange such units for Units of the Fund.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Consolidated Financial Statements

(Unaudited)

(Tabular amounts expressed in thousands of Canadian dollars)

6. Changes in non-cash operating working capital:

	Three month period ended June 30, 2005	Period from March 23, 2004 to June 30, 2004	Six month period ended June 30, 2005
Accounts receivable	\$ 434	\$ (3,802)	\$ (2,725)
Income taxes receivable	408	-	363
Inventory	(717)	(5,344)	(448)
Prepaid expenses	(610)	(94)	(375)
Accounts payable and accrued liabilities	2,522	(3,480)	2,068
	\$ 2,037	\$ (12,720)	\$ (1,117)

7. Segment disclosure:

Information about geographic areas is as follows:

	Three month period ended June 30, 2005	Period from March 23, 2004 to June 30, 2004	Six month period ended June 30, 2005
Revenue from external customers:			
Canada	\$ 30,223	\$ 30,640	\$ 57,247
United States	61,629	68,485	119,632
	\$ 91,852	\$ 99,125	\$ 176,879
		June 30, 2005	December 31, 2004
Property, plant and equipment:			
Canada		\$ 1,457	\$ 1,635
United States		1,878	3,052
		\$ 3,335	\$ 4,687
Goodwill			
Canada		\$ 42,043	\$ 42,043
United States		57,541	56,240
		\$ 99,584	\$ 98,283

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Consolidated Financial Statements

(Unaudited)

(Tabular amounts expressed in thousands of Canadian dollars)

8. Pensions:

Hardwoods USLP maintains a defined contribution 401 (k) retirement savings plan (the "USLP Plan"). The assets of the USLP Plan are held and related investment transactions are executed by the Plan's Trustee, ING National Trust, and, accordingly, are not reflected in these consolidated financial statements. During the three month period ended June 30, 2005, Hardwoods USLP contributed and expensed \$78,051(US\$ 62,787) (period March 23 to June 30, 2004 \$81,895 (US\$60,283)) in relation to the USLP Plan. During the six month period ended June 30, 2005, Hardwoods USLP contributed and expensed \$237,914 (US\$192,580) in relation to the USLP Plan.

Hardwoods LP does not maintain a pension plan. Hardwoods LP does, however, administer a group registered retirement savings plan ("LP Plan") that has a matching component whereby Hardwoods LP makes contributions to the LP Plan which match contributions made by employees up to a certain level. The assets of the LP Plan are held and related investment transactions are executed by LP Plan's Trustee, Sun Life Financial Trust Inc., and, accordingly, are not reflected in these consolidated financial statements. During the three month period ended June 30, 2005 Hardwoods LP contributed and expensed \$52,657 (period March 23 to June 30, 2004 \$45,982) in relation to the LP Plan. During the six month period ended June 30, 2005, Hardwoods LP contributed and expensed \$160,447 in relation to the LP Plan.

9. Related party transactions:

For the three month period ended June 30, 2005 the Fund made sales of \$495,876 (period March 23 to June 30, 2004 \$449,000) and purchases of \$40,522 (period March 23 to June 30, 2004 \$253,000) from affiliates of SIL. For the six month period ended June 30, 2005, sales of \$1,359,996 were made to affiliates of SIL, and the Fund made purchases of \$132,846 from affiliates of SIL. All these sales and purchases took place at prevailing market prices.

During the six month period ended June 30, 2005, the Fund paid \$58,976 (three month period ended June 30, 2005 \$25,704; period March 23 to June 30, 2004 \$24,204) to affiliates of SIL under the terms of an agreement to provide transitional services for management information systems. This cost is included in the selling and administrative expense in the statement of operations.

10. Contingencies:

The Fund and its subsidiaries are subject to legal proceedings that arise in the ordinary course of its business. Management is of the opinion, based upon information presently available, that it is unlikely that any liability, to the extent not provided for through insurance or otherwise, would be material in relation to the Fund's consolidated financial statements.

Unitholder Information

Trustees

Lawrence I. Bell
Chair, British Columbia Hydro
& Power Authority

Terry M. Holland
President, Krystal Financial Corp.

Graham M. Wilson
President, Grawil Consultants Inc.

Directors

Lawrence I. Bell
Chair, British Columbia Hydro
& Power Authority

Terry M. Holland
President, Krystal Financial Corp.

Graham M. Wilson
President, Grawil Consultants Inc.

E. Lawrence Sauder
Vice Chair, Sauder Industries

Richard N. McKerracher
President, Sauder Industries

Officers

Maurice E. Paquette
President and Chief Executive Officer

Robert J. Brown
Vice President & Chief Financial Officer

Daniel A. Besen
Vice President, California Region

Bryan R. Hoyt
Vice President, Pacific Mountain Region

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Transfer Agent

Computershare Trust
Company of Canada

