



**DESTINY RESOURCE SERVICES CORP.**  
**2005 Second Quarter Interim Report**  
**For the Three and Six Months Ended June 30, 2005**

**MANAGEMENT'S DISCUSSION AND ANALYSIS ("MD&A")**

*The following discussion and analysis of financial results for the three month and six month periods ended June 30, 2005 ("Q2'05" and "2005 YTD") and June 30, 2004 ("Q2'04" and "2004 YTD") is based on information available until August 9, 2005 (unless otherwise noted) and upon the Company's consolidated financial statements for the periods presented, which were prepared in accordance with Canadian generally accepted accounting principles, and should be read in conjunction with the Company's consolidated financial statements and Annual Report for the prior fiscal year ended December 31, 2004.*

*Forward-looking Information*

*Statements in this Management's Discussion and Analysis relating to matters that are not historical facts are forward-looking statements. Such forward-looking statements involve known (see Business Risks section) and unknown risks and uncertainties which may cause the actual results, performances or achievements of the Company to be materially different from any future results implied by such forward-looking statements.*

**REVENUE**

Revenue for Q2'05 was \$14.8 million, a \$13.6 million or 1,129% increase from the \$1.2 million in Q2'04. This increase caused revenue for 2005 YTD to increase by \$17.4 million or 124% to \$31.4 million compared to \$14.0 million for 2004 YTD. Revenues by quarter and year over year can be cyclical, and the current period reflects a significantly higher level of contract work performed, despite the fact that the Q2 period traditionally reflects weaker customer spending during the spring "break-up" period.

**GROSS MARGIN**

Gross margin for Q2'05 was \$2.6 million, a \$3.3 million or 456% increase from the negative \$0.7 million recorded in Q2'04. Gross margins also improved to 17.3% of revenues, compared to negative 59.8% in Q2'04. Gross margins for 2005 YTD increased by \$4.6 million or 237% to \$6.6 million compared to \$2.0 million for 2004 YTD.

The increase in Q2 and YTD gross margin dollars is attributed to such factors as:

- the increase in revenue for Q2'05 and 2005 YTD compared to Q2'04 and 2004 YTD.
- improved field efficiency achieved through decreased use of higher cost subcontractors and rented equipment.
- the Company's past efforts to alter its cost structure so that a greater portion of total direct expenses are variable as opposed to fixed, allowing improved margins as the smaller fixed cost component is spread over a wider revenue base. The lower level of revenues in Q2'04 thus resulted in a negative gross margin.

**GENERAL AND ADMINISTRATIVE ("G&A") EXPENSES**

G&A expenses, which represent primarily the costs associated with the corporate head office and the lease of the Survey & Mapping division's shop and office, totaled \$588,803 for Q2'05 and \$291,690 for Q2'04, a 102% increase for Q2'05. On a YTD basis, G&A also rose by 170% to \$1,576,276 for 2005 YTD vs \$584,219 for 2004 YTD. The new Kodiak division represents a portion of the increase in 2005 YTD G&A expense and ongoing accruals for the Company's new profit sharing incentive plans (\$833,000 for 2005 YTD) accounts for the majority of the increase.

The profit sharing plans are being instituted to align the Company's incentive compensation for key employees with the interests of shareholders. The plans, which replace bonuses and the grant of stock options, are intended to have the participating employees ever more focused on the Company's bottom line performance and to enable the Company to retain and attract operating and executive management in a competitive environment. Awards will be made one-half in cash and one-half in shares, purchased in the market.

## **AMORTIZATION OF PROPERTY AND EQUIPMENT**

Amortization of property and equipment increased by \$153,985 or 49% to \$471,437 for Q2'05 compared to \$317,452 for Q2'04 and increased by \$223,881 or 35% to \$862,714 vs \$638,833 for 2004 YTD. Amortization is a function of the timing of additions to property and equipment, with the net increase in 2005 primarily related to the \$2.0 million acquisition of the Kodiak division in January 2005.

Disposals of property and equipment resulted in a minor gain of \$38,183 for 2005 YTD compared to \$14,977 for 2004 YTD. These totals represent the normal course disposal of property and equipment with no noteworthy specific items.

## **INTEREST EXPENSE**

Interest expense declined by \$142,130 or 77% to \$43,378 for Q2'05 compared to \$185,508 for Q2'04 and similarly declined by \$358,440 or 86% to \$60,145 for 2005 YTD vs \$418,585 for 2004 YTD. Following the 2004 Rights Offering, as at the end of 2004 all long-term debt had been repaid by the Company, with 2005 interest reflecting only interest on the short-term bank operating facility, while at the end of Q2'04, total long-term debt was \$8.3 million. In addition to higher levels of debt in 2004, the facility that was in place in the early part of 2004 had higher ongoing fees which are also reflected in 2004 interest expense.

## **INCOME TAXES**

The Company did not have current taxes payable for the 2005 and 2004 Q2 and YTD periods, with minor "capital" taxes and expense related to an inactive subsidiary company recorded in 2004. The profitable operations in 2005 resulted in a draw-down of previously unrecorded future tax assets, and a resultant net future income tax expense of \$86,000 was recorded for the 2005 YTD period. The \$580,000 provision for future income tax expense recorded in Q1'05 was offset by a recovery of \$494,000 recorded in Q2'05, yielding a net 2005 YTD future tax expense of \$86,000.

## **SUMMARY OF QUARTERLY RESULTS**

A summary of operating results by quarter for the last 2 years is as follows:

<i>(in \$000's, except per share and # of share amounts)</i>	Q2 2005	Q1 2005	Q4 2004	Q3 2004	Q2 2004	Q1 2004	Q4 2003	Q3 2003
Revenue:								
Continuing operations	14,793	16,604	7,430	12,200	1,204	12,796	5,819	10,154
Discontinued operations	-	-	-	-	-	-	1,706	7,686
Total	14,793	16,604	7,430	12,200	1,204	12,796	7,525	17,840
Income (loss) from:								
Continuing operations	1,979	2,090	(421)	1,057	(1,437)	1,744	(1,030)	183
Discontinued operations	-	-	72	-	332	-	52	594
Total	1,979	2,090	(349)	1,057	(1,105)	1,744	(977)	777
Net income (loss) per share (basic & diluted):								
Continuing operations	0.36	0.38	(0.16)	0.40	(0.55)	0.66	(0.39)	0.07
Discontinued operations	-	-	0.03	-	0.13	-	0.02	0.23
Total	0.36	0.38	(0.13)	0.40	(0.42)	0.66	(0.37)	0.30
Weighted average # of shares outstanding (000s):								
Basic	5,548	5,495	2,636	2,636	2,636	2,636	2,636	2,636
Diluted	5,571	5,500	2,636	2,636	2,636	2,636	2,636	2,636

The above noted Summary of Quarterly Results highlights the following:

1. The Company's business is seasonal with Q1 and Q3 traditionally being the two strongest quarters and Q2 and Q4 normally being the weakest quarters. The underlying causes of the seasonality are weather conditions, the Company being restricted from entering and conducting work in designated wildlife areas at certain times of the year, and the timing of customer capital spending programs.
2. The effect of the Company's now discontinued operations can be seen in the 2003 revenue and income (loss) amounts.

## **LIQUIDITY AND CAPITAL RESOURCES**

Destiny's capital requirements consist primarily of working capital necessary to fund operations, capital expenditures related to the purchase and manufacture of operating equipment and capital to finance strategic acquisitions. Sources of funds available to meet these capital requirements include cash flow from operations, external lines of credit, equipment financing, term loans and access to equity markets.

During the 2005 YTD period, the Company increased its bank facility from \$5 million to \$10 million, with the ability to draw to \$18 million during the months of June through September. In addition, the rate on the facility was reduced to prime plus 1%.

The Company believes that it has the capital resources and availability to meet both its working capital and capital expenditure requirements for 2005 and beyond.

## **WORKING CAPITAL**

At June 30, 2005 the Company had net working capital of \$1.6 million, a 42% decrease from the \$2.8 million at December 31, 2004. The decrease in 2005 is largely due to the significant capex incurred, plus the payment of dividends, net of the operating cash flow of \$5.0 million. As at June 30, 2005, the Company's bank operating line of credit has been increased to \$10 million, with short-term availability rising to \$18 million for the months of June to September to meet expected increased contract activity.

Approximately 90% of accounts receivable at June 30, 2005 (67% at December 31, 2004) and 57% of 2005 YTD revenues were represented by sales to the Company's largest customer.

## **PROPERTY AND EQUIPMENT**

Property and equipment assets totaled \$9.1 million at the end of Q2'05, a \$4.1 million net increase from the \$5.0 million as at December 31, 2004. The increase is due to the \$2.0 million acquisition of Kodiak in January 2005, other net 2005 capex purchases totaling \$3.0 million, less amortization for 2005 YTD of \$0.9 million.

## **CONTRACTUAL OBLIGATIONS**

Upon closing of the Right Offering in December 2004, Destiny repaid all remaining long-term debt, and its' only future contractual payment obligations are in the form of operating leases on premises and equipment. The Company has no hedging or other "off balance sheet" contractual obligations.

	<b>Payments Due by Future Year</b>				
	<b>total</b>	<b>less than 1 year</b>	<b>2 - 3 years</b>	<b>4 - 5 years</b>	<b>after 5 years</b>
Operating Leases	\$ 2,195,213	\$ 547,330	\$ 722,637	\$ 570,810	\$ 354,436

## **SHAREHOLDERS' EQUITY**

As at the end of Q2'05, shareholders' equity increased by \$2.8 million to \$10.6 million compared to \$7.8 million at December 31, 2004. The increase is a result of 2005 YTD net income of \$4.0 million, share consideration issued on the acquisition of Kodiak of \$1.0 million, less 2005 dividends totaling \$2.2 million.

As at August 9, 2005, the number of issued and outstanding common shares is 5,547,581 with 83,500 additional common shares reserved for potential future issuance pursuant to options outstanding under the Company's stock option plan.

## **NEW CANADIAN ACCOUNTING PRONOUNCEMENTS**

The Canadian Institute of Chartered Accountants ("CICA") has issued a number of accounting pronouncements, some of which may impact the Company's reported results and financial position in future periods.

### *Comprehensive Income/Financial Instruments/Hedges*

The CICA issued new standards in early 2005 for Comprehensive Income (CICA 1530), Financial Instruments (CICA 3855) and Hedges (CICA 3865), which will be effective for the reporting year-end 2007. The new standards will bring Canadian rules in line with current rules in the US. The standards will introduce the concept of "Comprehensive Income" to Canadian GAAP and will require that an enterprise (a) classify items of comprehensive income by their

nature in a financial statement and (b) display the accumulated balance of comprehensive income separately from retained earnings and additional paid-in capital in the equity section of a statement of financial position. Derivative contracts will be carried on the balance sheet at their mark-to-market value, with the change in value flowing to either net income or comprehensive income. Gains and losses on instruments that are identified as hedges will flow initially to comprehensive income and be brought into net income at the time the underlying hedged item is settled. It is expected that this standard will be effective for Destiny's 2007 reporting. Any instruments that do not qualify for hedge accounting will be marked-to-market with the adjustment (tax effected) flowing through the income statement. Destiny does not have any hedges in place so there will be no impact based on current positions.

### **BUSINESS RISKS**

Destiny is subject to the risks and variables inherent in the oilfield services industry. Demand for the Company's products and services depends on the exploration, and to a lesser extent, development activities of energy companies. These activities are directly affected by factors such as oil and gas commodity prices, weather, changes in legislation, exchange rates, the general state of domestic and world economies, concerns regarding fuel surpluses or shortages, substitution through imports or alternative energy sources, changes to taxation or regulatory regimes and the broad sweep of international political risks such as war, civil unrest, nationalization and expropriation or confiscation, which are all beyond the control of the Company and cannot be accurately predicted. The oil market is influenced by global supply and demand considerations and by the supply management practices of OPEC. The natural gas market is primarily influenced by North American supply and demand and by the price of competing fuels.

The risks associated with external competition are minimized by concentrating Company activities in areas where it has demonstrated technical and operational advantages and by employing highly competent professional staff. Environmental and safety standards and regulations are continually becoming more stringent in this industry and Destiny is committed to maintaining its high standards. Destiny also mitigates business risks by establishing strategic alliances with reputable partners, developing new technologies and methodologies as well as investigating new business opportunities.

Given the Company's businesses are concentrated in the seismic services industry, the major business risk the Company faces is that revenues are subject to very wide seasonal and annual variations, all of which are beyond the ability of the Company to control while a meaningful proportion of the Company's costs are, at least in the short-term, fixed in nature. As a consequence, profits (losses) can vary widely from quarter to quarter and year to year. Destiny is also exposed to potential credit risk through its concentration of customers in the oil & gas exploration industry, and by its largest customer periodically accounting for a significant portion of Destiny's total revenues.

The risks inherent in the oilfield services industry impact the Company's ability to meet its financial covenants on its revolving, bank operating loan facility (of which \$3.7 million was utilized at June 30, 2005). Accordingly, the Company may become in violation of its covenants on the bank facility, which might result in repayment being demanded.

### **OUTLOOK**

Destiny believes that it has adequate working capital, cash flow from operations, and access to capital to fund ongoing business requirements. Management believes the Company has a cost structure that has sufficient variability as to be able to adapt to the volatility of its industry. The Company has experienced management, at all levels of sales, operations and administration, who are motivated to achieve success in both the short- and long-term. The Company provides services principally in connection with the exploration for a commodity, natural gas, which is escalating in value and is plentiful in the areas in which the Company operates.

Destiny periodically encounters expansion opportunities to consider. These involve, in each case, the requirement for capital expenditures beyond the normal course for the Company. Destiny may pursue any or all of these opportunities, and others that may present themselves. In doing so the Company may incur term debt, issue equity, and retain cash that might otherwise be paid as dividends or any combination of the foregoing.