TONUS CAPITAL INC.

Tonus Capital Inc.
1501 McGill College Avenue
Suite 2090
Montreal, Québec, H3A 3M8
Phone: (514) 844-4443
www.tonuscapital.com

SECOND QUARTER 2013 - NEWSLETTER

Dear Partner,

I am pleased to send you this portfolio review and commentary for the second quarter of 2013.

PERFOMANCE REVIEW

During the second quarter of 2013, the Tonus Composite increased **4.30%**. Over the same period, the performance of the S&P/TSX Total Return was **-4.08%** and that of the S&P 500 Total Return in Canadian dollars was **6.86%**.

Over the past 12 months, the Tonus Composite is up **30.74%**, against **7.90%** and **24.79%**, respectively, for the S&P/TSX TR and the S&P 500 TR $CAD.

Since the inception of the Tonus Composite in October 2007, it has achieved a compound rate of return of **10.75%**, compared with **-0.34%** for the S&P/TSX TR and **4.83%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW

The Tonus Composite registered adequate returns for the first half of 2013, gaining nearly 20% in value. Like last year, after a strong first quarter, markets took a little breather in the second quarter and (finally) experienced a certain degree of volatility in June. Leading the top four performers in the quarter was **Primerica (PRI - $37.44)**, a long-term Tonus holding. The other three were new additions in 2013; all have posted double-digit advances since their opportunistic purchase. As mentioned in the first-quarter letter, the recent market environment has been more favourable to selling than buying. As a result, close to a quarter (25%) of the portfolio was invested in cash-like short-term instruments at the end of the quarter. I welcomed the volatility in June as it might generate buying opportunities if investors over-react to short-term events. Two new positions were opened in Q2.

The first was **CST Brands (CST - $30.81)**, which went public when refiner Valero determined that the most tax-efficient way of monetizing its chain of convenience stores was through a spinoff. At an exchange ratio of 1 for 9, Valero shareholders were left with a small position in CST and many elected to sell before the shares were officially listed on the NYSE on May 2. I bought the stock on a when-issued basis in April at a discount to the $31 it fetched when it began to trade regularly. I like CST for three reasons. First, they operate most of their network in two regions that have more to offer than most, namely, the State of Texas and the Province of Quebec (under the Ultramar banner). What makes Texas a good market is that it is one of the states of the union with the lowest unemployment rate and the fastest economic growth.

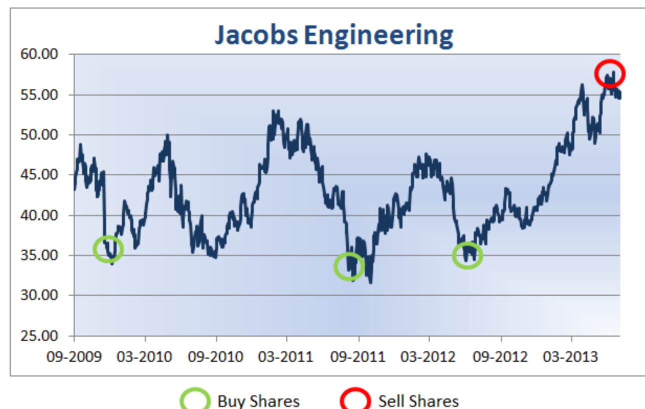
Quebec is appealing in that fuel retailing is regulated in the province to prevent selling below cost, and this boosts retailer profit margins (average 0.5 cent per litre higher).
Second, CST has the potential to improve its in-store merchandise profit margins, which currently trail industry leader Couche-Tard by 350 basis points. Some of this will be achieved through the opening of new stores. I had the chance to visit and see for myself why their larger size and internal layout redesign would lead to better margins. Though plans are for only about 25 openings this year, the impact could be noticeable. Assuming no improvement in the existing network, the new stores could raise overall merchandise margins by some 0.3% per year.
Finally, CST owns much more of its real estate compared with its competitors, an enviable asset that could be monetized down the road. In the end, as CST operates in a stable industry with a high return on invested capital and was trading at a discount to peers, I bought in.

The second new position established was in **BlackPearl Resources (PXX - $1.59)**, a producer of heavy oil in Western Canada. The company can be divided into two segments. First, existing operations produce close to 10,000 barrels of oil per day, generating annual cash flow of $75 million. Since present management took over in 2009, the company has doubled its average daily production. These assets alone, at an industry average multiple of 5.5x, are worth $425 million. The company was valued at $430 million when I bought the shares.
Second, they have two long-term SAGD (steam-assisted gravity drainage) projects that could more than quadruple production. These projects are massive; they could produce oil for more than 20 years but require a large capital investment up front. The stock price plunged when management decided to defer the financing and development of the first project: Onion Lake. The initial plan was to raise $350 million at a coupon rate of about 8%. When the debt markets tightened up in June and rates topped 11%, management wisely decided to postpone the issuance (merely delay–not cancel). I believe these assets hold value. Consequently, at the price the shares were purchased, we essentially acquired a piece of these assets for free.
BlackPearl currently owns 100% of both projects and has a clean balance sheet. Therefore, the company will not be cornered into making a short-term decision. Moreover, the company's top four executives own a total of 28 million shares, which means their interests are aligned with those of investors. This is a rarity among management teams in the oil patch. Of the 40 companies listed in the TSX energy sector, BlackPearl ranks fourth in terms of insider ownership.

Given the increase in our cash position in the portfolio, let me explain the rationale behind selling off two major positions during the quarter. Both **Chubb Corporation (CB - $84.65)** and **Jacobs Engineering Group (JEC - $55.13)** had been in the portfolio for more than three years. Both had returns of more than 60% from their initial purchase price. Both are great, well managed companies, but both had become fully valued at time of sale. Indeed, in both cases, most of the gain generated derived from an appreciation in valuation rather than a dramatic turnaround in financials.

In Chubb's case, the shares were initially purchased at $51 or just over 1.1x the company's book value per share at the time of $45. Over our holding period, management continued their wise capital allocation and used free cash flow to pay out $1.5 billion in dividends and to buy back $4.7 billion of stock above book value, which decreased the company's book value per share (the impact was approximately $7 per share). Still, at the end of the first quarter of 2013, book value stood at $56 per share. I sold the shares at $88, a gain of 80%. Why? At that price the book value multiple had reached 1.6x, the high end of Chubb's 10 year range.

For Jacobs, the stock was initially purchased at $37 when it was trading at an ex-cash free cash flow multiple of 11x. Analysts had assigned the stock a low multiple back in 2010 on the grounds of the company's weak organic growth and its large exposure to the petrochemical industry, which was then expected to decline substantially. As mentioned in our 2009Q4 letter, we believed Jacobs' business model would enable the company to maintain a healthy level of business in that sector. The stock fell back to this low multiple three times during our holding period and each time I seized the occasion to buy more. Fast forward to 2013: the stock is up 60%, free cash flow per share has grown 28% to $3.50, and the multiple has risen 30% to 15x. Wall Street is now assigning a higher valuation to Jacobs in part owing to its 50% exposure to the petrochemical industry, which is now seen as positive.



Both examples reflect my approach of finding good companies trading at a discount to intrinsic value. These are still two great, well managed companies, but the margin of safety disappeared when valuations reached historical peaks. They will nevertheless remain on my radar, and if their long-term business plan remains intact and their valuations return to attractive levels, I will certainly consider adding them back to the portfolio.

COMMENTARY

It will be interesting to see the effect on the markets of the tapering out of extremely favourable credit environments. We began to witness it recently, as market participants have grown more nervous. There were two main beneficiaries of this easy monetary policy: highly leveraged companies and high-yielding assets. These companies will soon see declining interest expenses reverse and the market could be quick to punish them by reflecting the refinance risk inherent in their financial model. Luckily, the Tonus portfolio contains very few companies with high leverage. Consequently, the end of the party is unlikely to have a material impact on us.

Where yielding assets are concerned, including junk bonds, REITs (real-estate investment trusts), dividend-paying stocks and high-grade corporate debt, these have been overvalued. Investors who lent Apple money in May are now realizing that fixed-income instruments can indeed lose value! Of the $17 billion raised, $5.5 billion was lent for 10 years at a fixed rate of 2.4% (at time of writing, 10-year U.S. Treasuries were yielding 2.5%). The bonds were issued almost at par. Today, they are trading at 92.89 cents on the dollar. With a 2.4% coupon, it will take investors three years to recoup their original investment, assuming no further increase in the yield to maturity. The same holds true for REITs, which have been very popular. Historically yielding 8%, they reached 4% in June before their value tumbled. There is no denying it: chasing yield can be a risky game.

I have never been driven by the dividend yield paid by stocks (the overall yield for the portfolio is 0.92%). What is much more important for me is the free cash flow yield, that is, how much I am paying for the money the business generates. Today, the free cash flow yield for the portfolio is 6.5%. I would qualify most of the companies held as great businesses. They generate high returns on invested capital (the average ROE for the portfolio is 16%). With such companies, we

will compound our investment at higher returns if free cash is reinvested in high-return projects. In addition, this is more tax efficient given that dividends are taxed as received whereas the capital gains tax is deferred until stock is sold. Again, the potential decline in value of high-yield assets in a rising interest rates environment should have no more than a minimal impact on the portfolio as dividend yield is not a factor that motivates my investment decisions.

Sincerely,

Philippe Hynes, CFA
July 8, 2013

Tonus Composite Performance Report
As of June 30, 2013

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
3 Month	4.30%	-4.08%	6.86%
6 Month	19.44%	-0.88%	20.60%
Year-to-Date	19.44%	-0.88%	20.60%
1 Year	30.74%	7.90%	24.79%
2 Years	24.57%	-1.60%	17.96%
3 Years	18.55%	5.39%	18.26%
5 Years	12.59%	-0.53%	7.77%
Since Inception (Oct. 31, 2007)	10.75%	-0.34%	4.83%

Source: Bloomberg Finance L.P.
All returns are gross of fees.
Please note that all returns greater than one year are annualized.

The Tonus Composite was created October 31, 2007. The firm maintains a complete list and description of composites, which is available upon request. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow of at least 25% of portfolio assets.
Investors should carefully consider the firm's investment objectives, risks, and expenses before investing.
Portfolio composition is subject to change at any time and reference in this letter to specific securities, industries, and sectors should not be construed as a recommendation to purchase or sell any particular security. Current and future portfolio holdings are subject to risk. The Composite return is not guaranteed; its value changes frequently and past performance may not be repeated.