● TONUS CAPITAL INC.

Tonus Capital Inc.
999 de Maisonneuve Ouest
Suite 799
Montréal, Québec H3A 3L4
Tel: (514) 844-4443
www.tonuscapital.com

FOURTH QUARTER 2018 - NEWSLETTER

Dear Partner,

Herein our portfolio review and commentary for the fourth quarter of 2018.

Performance

During Q4, the TONUS PARTNERS FUND decreased **-10.82%**. Over the same period, the performance of our benchmark (defined as 50% S&P/TSX Total Return and 50% S&P 500 Total Return in Canadian dollars) was **-9.40%.**

For 2018, the TONUS PARTNERS FUND is down **-11.66%** against **-2.60%** for benchmark.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved an annual compound gross rate of return of **9.20%**, compared with **6.48%** for the benchmark.

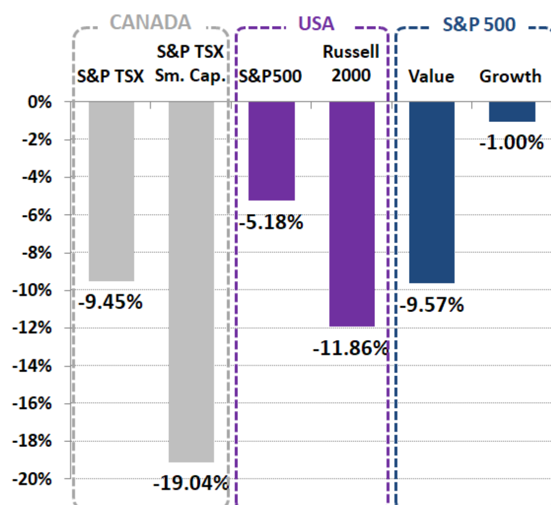
Quarterly review

The fourth quarter saw North American markets decline substantially and our fund follow suit. Let me be clear right from the start: I am disappointed by our performance. Our fund was holding on up to mid-November. However, our small-cap stocks then fell off a cliff as buyers were nowhere to be found at year end. The portion of our portfolio invested in these smaller companies had a -6.3% impact on our performance in December alone! While this was very disappointing, it was not, by and large, driven by fundamentals or company-specific news. It was the result of a broad-based exit of capital across the entire asset class. However, in such cases, the ensuing upturn can be as sudden and acute as the plunge. Indeed, many of the stocks in question have already bounced back more than 20% since hitting bottom around Christmas Eve.

This said, the fact remains that our Q4 numbers are far below where I would have expected them to be. While acknowledging that I have no control over short-term price fluctuations of our holdings, I reiterate that I am truly not pleased with this performance. What I do have control over is our investment process: invest in companies that can create shareholder value over the long term and acquire their stock when it is trading well below intrinsic value. As disappointing as December was, the lower prices that prevailed afforded a great opportunity to acquire more shares at depressed levels. These should yield strong returns down the road.

[1] Please see page 5 for a description of the Composite

The Year In Review



Source : Bloomberg

2018 was a tough year for stocks. As shown in the adjacent table, all North American indices, with the exception of large-cap growth stocks, registered marked declines in 2018. Unfortunately, small cap indices fared particularly poorly on both sides of the border, and it is precisely in small caps (market capitalization less than $3B) and mid caps that we have invested **80% of our portfolio**. Many of our stocks did not escape the massacre.

Why was it so? Let's take a look at what drives stock prices. Put simply, two variables explain price variations: a) a company's financial performance (earnings) and b) investor appetite to pay for those earnings (multiple). For each of our holdings, we thoroughly analyze earnings as part of our investment process. We have more control over this process, as we make our own assessment of the quality of past financial results and model our vision for future profitability. As for the multiple that the market assigns to our holdings, it depends more on what other investors are willing to pay for such earnings. In this regard, at year end, we reviewed the operational and financial performance of each of our holdings for the year relative to our internal expectations and compared it against its stock price fluctuation.

Financial Performance Vs. Market Performance

Generally speaking, we would expect stocks that exceed our expectations by a large amount to post strong returns; stocks that meet or only surpass our expectations by a little to have returns hovering around zero; and stocks that do not meet our expectations to decline. We assigned a grade to the financial performance of each of our holdings and you can see the list ranked by their weight in the portfolio. In many cases, the stock's annual performance reflected neither its financial performance over the year, nor our outlook for the future.

Performance of stocks in Fund		
Stock by weight	Financial Performance	Stock Performance
1	A+	34%
2	A	-13%
3	A	-7%
4	A	-8%
5	C	-32%
6	A	39%
7	B	-12%
8	B	-15%
9	B	0%
10	B	-1%
11	B	-29%
12	B	4%
13	B	-13%
14	B	4%
15	B	-17%
16	A+	4%
17	B	-7%
18	A	-25%
19	C	-75%
20	C	-76%

Companies with an excellent (A+) or good (A) financial performance should have seen their stock price rise. Instead, four of these declined during the year! Companies that had an average year (graded B) saw their stock price decline by 10% on average—an excessive drawback. As for the stocks that under-delivered during the year (graded C), we would expect their share price to decline, but not to the tune of 75%, as was the case for two of our smaller holdings. This duo alone lowered our return by approximately 5% in 2018. Though investors seem to have turned their backs on these companies, we expect them to rebound vigorously as they take measures to address their respective issues.

In light of this analysis, we can conclude that more value is inherently building up in our portfolio given that the market valuation of our holdings has not kept up with their operational and financial improvements. The stocks in our portfolio are trading at an average discount of 25% to their historical multiples.

Our value approach leads us to purchase securities when others shy away and to sell them when everyone flocks to them. Over the short term, we have little control over the market's enthusiasm for a given business. Over the long run, however, all good businesses end up being priced appropriately. That's when we benefit, provided that we acquired their stock at a good discount. We believe December was a great time to purchase more shares of stocks where the disconnect between market price and company value was widest. Moreover, some stocks that we had been eyeing for some time began looking like great deals. This was the case for Dollarama, which we purchased in the past quarter (detailed explanation on page 3). Other high-quality businesses on our watch list, could be added soon as well.

An Analogous Real Estate Play

There is an analogy to be drawn in these uncertain times with a prudent real estate investor. Let us consider a well maintained four-unit building, in a borough not too far from a city's downtown core. It's not the hottest or the fastest growing market, but the area is stable and possesses many attractive qualities. In this scenario, we own one of the four units in the building.

The demand for housing in this area is normally strong and there is a steady turnover in the population, as young couples move to the suburbs when they decide to form a family. Now suppose that, in a given year, the three other units in the building happen to be vacated at the same time. The owner of these units has trouble finding tenants and, faced with mounting bills, decides to part with one or more units at what seem to be quickly depreciating prices. The market price of our unit would decline temporarily, to be sure, but knowing the demographics of this borough and estimating that new tenants will inevitably come knocking in due time, we gladly seize the opportunity to purchase another unit at a discount to its true value and then exercise our greatest virtue: patience.

The stock market went through a fire sale of sorts in December, when volatility, combined with a less certain short-term economic outlook drove buyers away. Over the long run, companies that reinvest their cash wisely (proper property maintenance), operate in a good industry (good neighborhood), and generate stable free cash flows (rent from tenants) will eventually rekindle investor interest. Our patience, then, will be well rewarded.

From Growth To Value

Dollarama (DOL - $32.47) is the largest dollar store chain in Canada with 1,192 locations. Its corporate mission is to "provide *customers* with compelling value". Contrary to the low-priced items sold in its stores, its stock has traded at high prices with growth investors loving its pipeline of new stores and strong organic growth. However, we would argue that only recently has Dollarama begun "providing *investors* with compelling value", that is, only after its earnings multiple shrank from a high of 31x to a low of 17x over the course of 2018. The stock had not been at such a valuation since 2011. After years of same-store sales growth in the range of 5% to 7%, Dollarama decided not to raise prices this year in order to maintain its compelling value proposition relative to its non-dollar-store competitors. The decision will reduce their organic

growth temporarily. This, combined with a negative report published in October by an American short seller[2], sent investors running for cover.

At the discounted Q4 prices, we acquired shares in a high-quality company that has proved able over time to generate a return on capital north of 25%, a feat almost unheard of in retail. Benefiting from a strong purchasing department and some of the best locations in the country, Dollarama has been able to drive away smaller competitors in the dollar store category and to become a popular shopping destination for Canadians. There is still room to grow, as they could open another 500 locations over the next 5 to 10 years. We believe further penetration is still possible in Montreal (30 stores) and Toronto (60 stores), but we think opportunities exist to increase their store count especially out West (240 stores) where they have a lower number of stores per capita and to expand further in rural areas (170 stores).

Combined with the targeted price increases we have started to see in the pricing database we maintain, good cost control, and share repurchases, we believe earnings per share can return to double-digit growth. In the low $30s where we bought shares, DOL exhibits what we look for in a value investment: a very low chance of seeing the share at a lower price in two years (low risk) and a good chance of seeing the stock significantly higher over the same time frame (high opportunity).

Optimism Looking Forward

While 2018 did not close the way we would have liked it to, the year end nonetheless afforded plenty of opportunity for bargain hunting. Although stocks have rebounded from their trough, many of them, particularly the smaller companies, are still trading significantly below their intrinsic value. We will not be changing our investment style. Many investors are fearful right now and are exiting the market. We will stick to our game plan, remain disciplined about when to buy and sell, and maintain our long-term vision. Our cash balance now stands at its lowest point in years and we are very optimistic about the gains we should witness in the coming quarters.

Sincerely,

Philippe Hynes, CFA
January 16, 2019

---

[2] Shorting or short selling is when investors borrow shares and immediately sell them hoping to be able to buy them again at a lower price later, and return them to the lender, pocketing the difference.

For reference, find below the historical gross returns of our North American equity strategy:

Tonus Composite Performance – As of 12/31/2018

	Tonus Composite (Gross Returns)	*Index*
3 months	-10.82%	-9.40%
6 months	-10.87%	-7.06%
YTD	-11.66%	-2.60%
1 year	-11.66%	-2.60%
2 years	-4.65%	4.16%
3 years	4.34%	7.45%
5 years	4.64%	8.94%
Since Inception	**9.20%**	**6.48%**

Source: FactSet Research Systems, Inc.
Returns are gross of fees and are calculated using a time-weighted rate of return. Past performance is not indicative of future results. Returns greater than 1 year are annualized. Benchmark consists of 50% S&P/TSX TR Performance ($CAD) + 50% S&P500 TR Performance ($CAD). S&P500 TR ($CAD) is adjusted for US dividend withholding taxes

Please note that Tonus Capital serves as the investment manager for the Tonus Partners Fund. Historical returns shown are for the Tonus Partners Fund. Prior to January 2016, the returns are from the Tonus Select Fund from October 2007 to October 2011 and from the weighted average of all managed accounts (including those accounts no longer with the firm), using the same strategy implemented in the actual Tonus Partners Fund, from November 2011 to December 2015. Although the structure and the name of the investment product changed, it had for the entire period the same investment mandate, objectives, strategy and benchmark. Past returns are not necessarily indicative of future performance. At any moment, the portfolio composition may vary widely from a 50/50 CAD/USD split as it is for the benchmark. Returns are gross of fees and in Canadian dollars. Any investment in the Fund is speculative and involves substantial risk, including the risk of losing all or substantially all of such investment. This document is not to be construed as a public offering of securities in any jurisdiction in Canada and is for informational purposes only. While the information and material in this document are believed to be accurate at the time they are prepared, Tonus Capital Inc. cannot give any assurance that they are accurate, complete or current at all times. The Tonus Composite was created October 31st, 2007 and the Tonus Partners' Funds was created January 4th 2016.