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THIRD QUARTER 2019 - NEWSLETTER

Dear Partner,

We are sending you this portfolio review and commentary for the third quarter of 2019.

Performance

During the third quarter of 2019, the TONUS PARTNERS FUND decreased **-2.39%** (gross of fees). 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 **2.73%**.

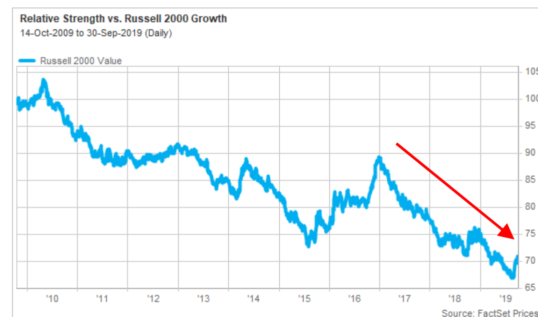
Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound rate of return of **8.23%**, compared with **7.53%** for the benchmark.

Quarterly review

Despite closing the quarter with slightly negative returns, we made good progress during the period and started seeing positive signs emerge. After a very long wait, value stocks finally did better in early September, and so did your portfolio. As money rotated into value names, our fund shot up almost 5% in the span of a few days while the market was relatively flat. Ultimately, however, the market left the dinner table quite early, and the month ended up being merely good, not great. Still, this has given us renewed optimism that, at last, value stocks are once again part of the conversation.

Difficult macro environment for value investors

In the past ten years and especially in the past three, we have operated in an environment where investors and speculators alike have tended not to penalize failure when it comes to generating new business models. As the graph here shows, growth and momentum stocks have been the clear winners in this trend, consistently outpacing value stocks through the last decade; culminating with a massive 22% outperformance since 2017!



Relative performance of value stocks vs. growth stocks: Down curve means value underperformed growth

Moreover, a glut of capital has given light to a host of large private and public companies, most of which generate no profits: This is the case for 40% of the companies in growth indices. To their credit, these companies have grown by introducing new practices and disrupting their specific industries in the interest of consumers. So far, investors have rewarded their potential and willingly overlooked their massive losses. This has been true, for example, for WeWork

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

(basically a commercial real estate leasing company), Uber (basically a taxi company) and Compass (basically a real estate firm).

We do not, on principle, invest your capital in this sort of vehicle. We prefer to minimize risk and put the odds in our favour by seeking to understand long-term metrics tied to real profits and real cash flows. This is much harder to do, if not impossible, with emerging ideas, novel businesses, and newly minted industries.[2] Contrary to trends prevailing in the last few years, we witnessed in September the beginnings of what we hope is the market's long due re-acquaintance with value stocks. This renewed relationship is not exactly fervent at this point in time, but we are heartened to see that, at least, it has been rekindled. Thanks to this and to company-specific catalysts expected in the coming months (e.g., contract wins and financial results), our portfolio should soon soon break out of its current doldrums.

Macro main culprit, but micro not exempt from blame

While market trends have been a headwind for us, factors under our control, also, have impacted our performance. Although the majority of our stocks registered positive returns, these were offset by larger losses incurred on a few specific companies. Analyzing the stocks that had the biggest negative influence on the portfolio, we realized that they had two things in common: a very small market capitalization and more volatile earnings. As investors are faster to lose interest the smaller a company is, two of our smallest companies (by market capitalisation) plunged and significantly impacted our returns over the past two years to the tune of more than -4% each. We came to the painful conclusion that we had been wrong in these two cases and took the prudent decision to sell off these shares. As a result, our exposure to cyclical stocks has gone down and the median market capitalization of our portfolio has gone up.

Another reason for our flat returns is that earnings seemingly do not matter right now. Indeed, while many of our stocks reported good to strong financial results this past quarter, the stock reaction was frustratingly muted. The recipe for value to be acknowledged is to show consistency in results. Consequently, we eagerly await the next releases, which should drive our shares to outperform.

When it rains, it pours

To top things off, in September, SprucePoint, a New York hedge fund, released a negative report on one of our holdings: **Premier Inc (PINC - $28.92)**. PINC is the manager of a group purchase organisation, or GPO, which acts as an alliance of hospitals to drive purchasing costs lower. As a result, the stock fell and shaved several basis points off our return late in the third quarter.

Coincidentally, the report came from the same group that published a negative piece on **Dollarama (DOL - $47.43)** almost a year ago, which caused DOL stock to drop 20%. We read that report, did our own analysis and due diligence, and concluded that most of the allegations made were unfounded and did not materially alter the company's long-term earnings potential. We took advantage of the panic that ensued to buy shares of DOL in the low $30s. We still own the stock. It was recently trading at $48, a 50% increase in less than a year! We reviewed the

[2] Case in point: In their recently shelved IPO, WeWork used a profitability metric labelled *Community Adjusted EBITDA* which, when boiled down, was whatever they wanted it to be. Through this sleight of hand, their 2017 adjusted EBITDA losses of $193M turned into a profit of $233M once sales, marketing, market development and opening costs disappeared.

hedge fund's track record on the 40 reports published between January 2016 and July 2019. On average, the target stocks sank 11% in the wake of the report. However, these same stocks are now, on average, up 32% from those levels! In the end, SprucePoint seems good at alarming investors in the short term. Over the long term, fundamentals tend to prevail.

Where PINC is concerned, SprucePoint contended that members of the GPO would leave for better economics from a competing plan. We acknowledge that the revenue split might tilt towards members, but we believe that the extent of the change will be much smaller than implied in the report, which fails to take account of some of the fiscal and operational benefits that members receive through Premier. We contacted members who confirmed that the revenue split was not the primary reason for doing business with Premier. At current levels, the stock is trading at 10x earnings. Even in a scenario where contracts are renegotiated downward AND 15% of the members leave the organization, Premier would still generate $2 in earnings per share, which would support today's stock price. With such an attractive risk/reward profile, we increased our stake in PINC and expect the stock price to turn around as soon as investors realize that SprucePoint's report is flawed and inaccurate.

New additions to the portfolio

First, **Cineplex Inc. (CGX - $24.26)** needs no introduction given its 75% market share in Canada. This purchase might come as a surprise. Many people believe that online streaming has sounded the death knell for movie theatres. However, their demise has often been predicted in the past: in the 1950s with the advent of television, in the 1980's with advent of VCRs, and in the 2000s with the advent of DVDs. Instead, the box office has continued to climb and reached record levels in 2018. The decision to invest in CGX was made not on the basis of this being a high-growth business, but rather on the belief that significant value can be created through the wise deployment of high free cash flows generated by this quasi-monopolistic business (more than $100M per year). The theater segment alone has, according to our analysis, a value of $20 per share.

Consequently, we paid very little for the other parts of the business, namely: a) Cineplex Digital Media, an installer and operator of digital signage media; b) Player One, the largest distributor and operator of amusement gaming (arcades) in North America; and c) Entertainment and Leisure, which owns and operates entertainment venues such as Top Golf and The Rec Room. These are growth segments that generate a good return on invested capital, reduce box office cyclicality, and have been growing at a rate of over 20% per year. While management proves their ability to create value from these investments, we will receive a hefty dividend yielding 7.6% on our cost base.

The second stock that we purchased will be familiar to investors in our fund: **SS&C Technologies (SSNC - $51.57)** is our fund's third-party administrator. Having used their services for many years, we are familiar with their business and can testify to the stickiness of their offering: The last thing their clients want is to change providers. As a result, SS&C enjoys a 95% revenue retention rate! Founder and CEO Bill Stone, who holds 34 million shares, has been applying the same formula since 1986: Buy companies in the same or a similar line of business, take costs out, improve margins, grow. Concurrently, they are spending significant dollars in research and development to improve their offering. Today, the company offers a full suite of products that covers various operations that financial institutions prefer to outsource.
The opportunity for us to acquire shares arose because they are experiencing short-term hiccups related to their two latest acquisitions. At the current historical low P/E valuation of 12x,

investors have written off their long-term ability to create value through acquisitions. Begging to differ, we acquired shares at a great price.

Patience

We understand that your patience is being tested of late. Ours is as well. Our portfolio contains many stocks with a story similar to Premier's: Negative news emerges, investors flee, the stock drops with no floor in sight, and even if results are good, they make no difference on the stock price. Well, this is what happens in the short term. However, the market is rational and eventually sorts things out. Many of our names have considerable upside potential. We just cannot say when exactly it will be realized by investors and reflected in our numbers.

Green shoots of value have emerged, company-specific catalysts are in the offing, and new investments have been made in promising companies. All of this argues in favour of better times ahead.

Sincerely,

Philippe Hynes, CFA
October 16, 2019

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

Tonus Composite Performance – As of 09/30/2019

	Tonus Composite (Gross Returns)	*Index*
3 months	-2.39%	2.73%
6 months	-3.65%	5.07%
YTD	-3.95%	17.92%
1 year	-14.34%	6.83%
5 years	2.15%	9.86%
10 years	9.71%	11.18%
Since Inception	**8.23%**	**7.53%**

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.