● TONUS CAPITAL INC.

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THIRD QUARTER 2022 - NEWSLETTER

Dear Partner,

We are pleased to send you our portfolio review and commentary for the third quarter of 2022.

Performance Review

During the third quarter of 2022, the gross return for the TONUS PARTNERS FUND was **7.6%**. Year-to-date, the Fund has achieved a gross return of **-6.9%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound gross rate of return of **8.8%**, compared with **6.7%** for the benchmark[2].

Quarterly Review

Long summer days at the beginning of the third quarter warmed investor sentiment and turned their fancy back to stocks, driving prices up in the process and erasing a good portion of the losses registered in the first half of the year. By late August, however, the ardour abated, and investor attention was once again captivated by inflation, interest rates, and geopolitical risks. As a result, gains recorded by North American indices earlier on were wiped out and both Canadian and U.S. markets ended up with another quarter in the red. **Our Fund did not share this fate**. We, instead, posted an excellent gain of 7% for the period. Many of our investments had fantastic financial results and one stock took off when the company was bought out by a rival. We took advantage of the rebound to sell off holdings whose upside-to-downside ratio had lost some of its shine. We were also busy buying new names. The higher the market volatility, the more active we are to take advantage of the mispricing of selected securities with a view to maximizing returns and minimizing risk.

Risk management is key for investors who wish to build wealth in a durable way over a decade-plus horizon. As we have seen this year, markets will hit speedbumps and negative surprises will hit stocks. In the very long-run, markets will go up, but in order to participate in this wealth creation, investors need to remain in the game and survive the dips. What we find interesting is how much of a difference prudent investing can make in times when it counts most, i.e., during a market downturn.

A large swath of funds are experiencing huge declines this year, potentially destroying years of gains. Our Fund, down only 6.9% year to date, has reacted as expected. Our 2-, 3- and 10-year performances remain well in positive territory. To put this in perspective, a fund down 50% this

[1] Please see page 4 for a description of the Composite.

[2] Please see page 4 for a full description of the benchmark along with its historical returns

year (relative to our -7%) would have needed a 65% return per year in the two preceding years just to match our 3-year return! While we certainly strive for high returns each year—and we have had some in the past[3]—our focus is more on avoiding 50% drops and keeping returns stable. We may never win the *Fund of the Year Award* for highest return, but we are fine with that. We are running a marathon, not a sprint. Put another way, the magic of compound interest creates more wealth the more consistent the results are.

So far in 2022, stock prices have declined owing to rising interest rates pushing down valuations: investors are lowering the multiple they are ready to pay on a firm's estimated future profits. To our astonishment, these profits are still expected to swell 8% for the year ahead. In our opinion, investors do not seem to be factoring in the risk of these estimates turning out to be overly optimistic. As we wrote in our second quarter letter, profits held up nicely in the first half of the year, essentially because companies worked through their backlogs and raised prices. However, their ability to keep pushing prices up will diminish. While this will be great for taming inflation, it will put pressure on margins, profits and, ultimately, share prices.

The Word this Quarter: Valuation

Our message to you so far this year was centred on inflation. In our Q1 letter, we detailed how we had invested in companies that should benefit from rising inflation. In Q2, we explained why we believed our main holdings would be able to manage rising costs and interest rates. In this letter, we would like to focus on valuation. Inflation creates uncertainty, which brings volatility. In this environment, investment decisions need to be grounded more than ever on valuation. This has always been our approach: assess the long-term value of an asset and wait for it to be mispriced to acquire it at a discount. In times like now, opportunities abound for us.

To determine this long-term value, we first think about how the business operates in various economic environments. We further differentiate ourselves by building our own internal financial models which are used to value stocks based on discounted cash flows. Moreover, we use our models to forecast future earnings and compare them to the market's expectation (analysts expected earnings). At times, prices get pumped up too much by investor euphoria. This reduces our margin of safety and increases our risk. In this case, we sell. At other times, investors let too much air out of stocks. This renders long-term earnings multiples very attractive and gives us ample protection should our projections turn out to be excessively optimistic. In this case, we buy. Let us look at a couple of examples where we applied these principles this past quarter.

VerticalScope Holdings (FORA - $10.00) is a company we discovered at the time of their IPO roadshow in 2021. Led by its founder, Rob Laidlaw, who still owns 14% of the shares, FORA operates digital community platforms for online enthusiasts. Most of the content on these sites is produced by its more than 100 million monthly active users, which are monetized through advertising and e-commerce solutions. The company went public at $18 per share but we decided to pass, doubtful that the strong results posted during the pandemic would be replicated in a more normal environment. We monitored the company, keeping our model up to date on a quarterly basis and waiting for an entry point that would afford greater downside protection.

We finally got it in August, when investors, fearing a decline in advertising dollars, drove the stock price from $22 to under $8! We kept a cool head and turned to our model. We expected them to generate $1.25 in free cash flow this year. As they report in U.S. dollars, this translated into $1.70

[3] Our North American strategy had a gross return of 39.9% in 2013, 25.0% in 2016 and 20.0% in 2020.

in Canadian dollars. We bought at $7.50, just under 4.5x this amount. The yield on cost would be 22% if the company decided to pay out all of this free cash flow to shareholders in the form of dividends! Even high-risk junk bonds are not trading at this level. Were the economy to slow down and advertising rates to decline, the company's organic growth might decelerate but they would remain profitable. Plus, the valuation at time of purchase gave us a comfortable margin of safety. When Q2 results were published, they came in strong, and the stock shot up more than 50%. We will keep tracking their results, updating our model, and managing the weight of this stock in our portfolio relative to our safety margin.

Napco Security Technologies (NSSC – $29.08) is a stock we purchased in the spring and discussed it in our 2Q letter. At the time, we assessed the value of the stock at $35. Our $18 purchase price significantly lowered our risk should our growth assumptions prove too optimistic. In just a few weeks, the stock moved to $30. While we were slightly more confident at this point about their growth trajectory, we believed the upside left was too small to justify Napco's considerable weight in our portfolio. We decided to sell half our shares and wait to see how future financial results fare against stock price movements. If the price drops unmotivated by negative developments, we will be ready to increase our position again. If the price rises, we will enjoy further gains by selling more or all of the stock if we feel its value has been realized in full.

One stock exited the portfolio in the third quarter. We acquired stock in **IBI Group (IBG - $19.50)**, an engineering and architectural firm based in Toronto, in March 2021 when a group of employees sold a block of shares at $10. Using our valuation framework, we calculated the stock was trading at 8x EBITDA, a significant discount relative to its peer group trading at 14x. The company's smaller size warranted a small discount, but we felt the stock could eventually trade at 12x, which meant a stock price of $18. In Q3, Arcadis, a Dutch competitor, acquired the business at the fair price of $19.50 per share. This made for a great return for us over the short amount of time that we held it in the portfolio.

As we head toward winter, we will continue to approach our capital deployment in the same manner illustrated by the above examples. The current negative mood among investors may last longer. This could create more opportunities for us. At some point in the future, the bears will turn back into bulls. Investors will start looking beyond current pressures and focus on earnings growth and attractive long-term valuation. We are positioning our portfolio to shield it from steep declines, while remaining poised to benefit from the rise in stock prices down the road.

Tonus Corporate Update

Finally, great news at the corporate level: Aaron Warnongbri has been made partner of the firm. Aaron and I have worked together now for more than nine years. In addition to overseeing operations and compliance, he also helps me manage the Fund. We share the same values of honesty and respect, and I can assure you, our partners, that he will always put your interests first. I am quite fortunate that our paths crossed at Concordia University. He has proven an invaluable asset to the firm, which will continue to benefit from his sharp insight and foresight as we and the rest of the team pursue our journey to create wealth for you over the long term.

Sincerely,

Philippe Hynes, CFA
October 5, 2022

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

Tonus Composite Performance – As of 09/30/2022

	Tonus Composite (Gross Returns)	*Index*
3 months	7.6%	0.4%
6 months	-3.3%	-15.2%
YTD	-6.9%	-15.7%
1 year	-8.7%	-11.1%
3 years	11.2%	7.4%
5 years	3.8%	6.7%
10 years	9.3%	9.7%
Since Inception	**8.8%**	**6.7%**

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 25% S&P/TSX TR Performance + 25% S&P/TSX SmallCap Index performance + 25% S&P500 TR Performance ($CAD) + 25% Russell 2000 TR Performance ($CAD). S&P500 TR ($CAD) and Russell 2000 TR ($CAD) are 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 the benchmark. The benchmark was changed to the current format starting in 2021. Prior to 2021, the benchmark presented was calculated by taking 50% of the performance of the S&P/TSX and 50% of the performance of the S&P500 in Canadian dollars. Would you like to see the historical benchmark returns, please follow this link. 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.