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FIRST QUARTER 2018 - NEWSLETTER

Dear Partner,

Here is our portfolio review and commentary for the first quarter of 2018.

Performance Review

During the first quarter of 2018, the Tonus Partners Fund was down -**5.14%**. 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 **-1.24%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound rate of return of **10.65%**, compared with **7.10%** for the benchmark.

The market in context

After watching technology stocks continue their rally early in the year, we were starkly reminded over the past few weeks that markets are not a one-way street. We had been expecting greater volatility for a while... and we were well served in the first quarter as it returned with a vengeance! For the first time in over a year, indices lost in excess of 2% on more than five trading days and, at the end of March, the market registered its worst week in more than two years as it retreated 6%. Investors who had been pouring money into passively managed funds bolted for the exits. For example, the SPDR S&P 500, one of the most popular exchange-traded funds around, suffered record outflows of $23 billion over the span of one week, amounting to 8% of its assets.

As passive funds sold off shares indiscriminately in order to cover these redemptions, all the sectors of the index fell but one: Technology. Thus, 2018Q1 was the first quarter in more than two years where the S&P 500 registered a decline. The Canadian market, for its part, was once again one of the worst markets globally after lagging significantly last year. It was down -4.5% in the quarter owing primarily to the weakness of two sectors: Energy (-10%) and Mining (-5%).

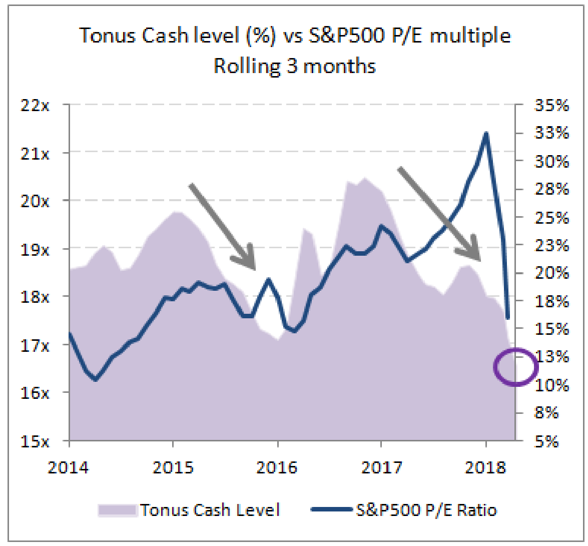
How did we fare?

Flush with cash at the beginning of the year, we were well positioned to enter this market. We did two things in response to the heightened volatility: a) assess the weights of all of our investments on an ongoing basis in order to increase/decrease them as warranted; and b) seek out attractive new opportunities among stocks being sold off all too eagerly. Consequently, we were very active, but the positive impact of these transactions will not be felt until later in the year.

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

That said, our performance of -5.1% in Q1 was clearly disappointing. However, given that two-thirds of the stocks in our market declined, it came as no surprise that, in this first leg down, many of our holdings did as well. Two factors accentuated the pullbacks in our case. The first is the degree of concentration of our portfolio and, as you know, the bigger the weights, the bigger the repercussions. The second is our exposure to smaller-cap stocks. Needless to say, in times of panic such as we just witnessed, these are liable to be much more volatile owing to limited liquidity. In fact, this factor explained nearly all of our loss. Indeed, the steep decline by two of our largest investments—both small-cap companies—accounted for four percentage points of our negative return in the quarter! We still believe the investment thesis underlying these purchases to be valid, so their current lower stock price renders them even more alluring. This is why we did not hesitate to accumulate more of these shares under the circumstances. Ultimately, the return on these should be even bigger than initially anticipated.

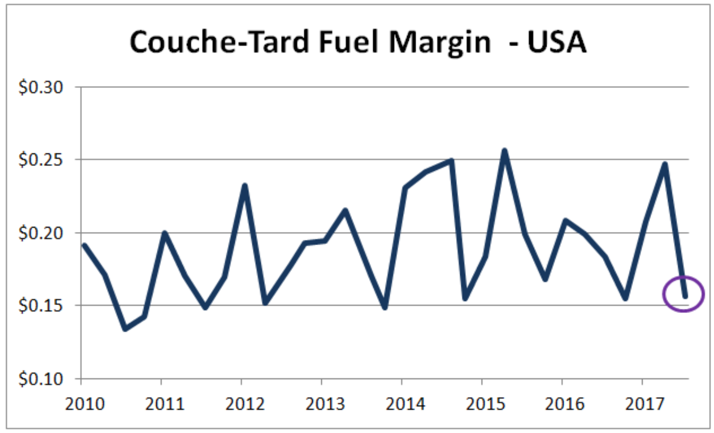
You have probably grown tired of hearing about the challenge of unearthing bargains in a bullish environment and of how our elevated level of liquidity, at 20% to 25% for much of 2017, detracted from our performance. We were waiting for great opportunities to present themselves before deploying our cash. Our patience was rewarded in Q1. As shown in the graph here, when market multiples started to come down, bargains finally arose and we invested more than half our cash, adding to our holdings in six existing stocks and initiating two new positions (one described herein, the other we are still buying). We expect to deploy the rest of our cash in the near future as more deals are bound to pop up in the current market.



New stock

After waiting six years for the right time to buy, the window finally opened for us to purchase shares in one of the best operated companies in our universe: **Alimentation Couche-Tard (ATD.B - $57.67)**. At the time of its IPO in 1986, Couche-Tard operated a grand total of 34 stores. Today, it operates more than 12,000 in 12 different countries. The stock had been on a tear for years, driven by strong execution, strong margin expansion, and a flawless acquisition/integration strategy. As a result, Couche-Tard has managed to sustain return on equity north of 20% while maintaining a very manageable debt level. This ensured that the stock consistently traded at a premium. A year ago, the stock started trading sideways on investor expectations that Metro, which owned 32 million ATD shares, would liquidate most of these in order to fund its own growth. On October 11 of last year a large block of shares was traded at a discounted price of $57.17. Unfortunately, we were unsuccessful in our bid to acquire as many shares at this great price as we wanted. We were all the more sorry in that their price quickly climbed back into the high $60s in short order.

Since then, Couche-Tard reported a quarter below expectations and, after peaking at $68 in December, the stock dropped to $56. Adjusted for currency effects (most of Couche-Tard's earnings are in USD), the stock was down 21% from two months earlier owing to what we believed were essentially transitory issues. Most of the shortfall sprang from the fact that fuel margins were tighter than expected. As we can see from the graph, the recent narrowing was not out of the ordinary. Indeed, fuel margins remained within the historical band of 15 to 25 cents per gallon. Moreover, the company is still in the process of integrating CST, which it acquired the year before. Despite the enhanced synergy ($215 million compared to a previous estimate of $175 million), the lower performing CST stores have exerted some downward pressure on Couche-Tard's operating metrics, but this, too, in our opinion, is nothing but a temporary issue.



In terms of valuation, Couche-Tard was back to its 2013 levels. Share price had been flat for the past two and half years despite operating profits growing almost 50%. Notwithstanding its current intense capital expenditure program, the company is still expected to generate more than $1 billion USD in free cash flow this year. This will fund future acquisitions which, for us, constitute the main driver of shareholder value at Couche-Tard. At 14x earnings, with more synergy yet to come from recent deals and with additional initiatives to drive both organic and inorganic growth, we felt we were at a very attractive entry point that carried limited downside risk.

Optimism for the future

In closing, while we are not pleased with our Q1 performance, we remain **very optimistic** about the quality and valuation of our current holdings. On a weighted average basis, the current valuation of our portfolio is 14% more appealing than it was a year ago (our portfolio trades at a multiple of 13.9x compared to 16.2x at the end of 1Q17). We believe that we understand how and why our opinions differ from those of other investors, and we assess the upside-to-downside ratio of all our holdings on a continuous basis. At their current prices, we are enthused by the fact that the probability of our stocks going up is high and that the expected gains far outstrips the potential decline. As these companies report good financial performances, we expect investors will start recognizing the merits of their business models and will realize just how attractive their valuations are. With a much lower level of cash, our portfolio stands to benefit greatly when this occurs, which is why we believe very strong returns are in store for us down the road.

Sincerely,

Philippe Hynes, CFA
April 20, 2018

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

Tonus Composite Performance – As of 3/31/2018

	Tonus Composite (Gross Returns)	*Index*
3 months	-5.14%	-1.24%
6 months	-1.78%	4.32%
YTD	-5.14%	-1.24%
1 year	-3.87%	5.83%
2 years	7.91%	12.55%
3 years	7.45%	7.70%
5 years	10.47%	12.71%
Since Inception	**10.65%**	**7.10%**

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.