TONUS CAPITAL INC.

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

# FIRST QUARTER 2012 - NEWSLETTER

Dear Partner,

I am pleased to send you this portfolio review and commentary for the first quarter of 2012.

## PERFOMANCE REVIEW

During the first quarter of 2012, the Tonus Composite increased **10.04%**. Over the same period, the S&P/TSX Total Return grew **4.39%** and the S&P 500 Total Return in Canadian dollars rose **10.51%**.

Over the past 12 months, the Tonus Composite is up **14.35%**, against **-9.76%** and **11.69%**, 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 **7.20%**, compared with **-0.83%** for the S&P/TSX TR and **1.23%** for the S&P 500 TR $CAD.

## PORTFOLIO REVIEW

For a second consecutive quarter, the portfolio registered strong double-digit returns and outshone the markets. Despite the U.S. dollar’s negative impact on performance on the order of roughly 3.5% over this six-month period, the portfolio was still up 22.4%. Generally speaking, with valuation multiples rising in the majority of industries, screaming-buy stocks are now harder to come by. Nonetheless, two new positions were added during the quarter.

The first is **Carbo Ceramics (CRR - $105.45)**, a manufacturer of high-end ceramic proppant used in the hydraulic fracturing of oil and gas wells. In the past five years, oil and gas exploration has undergone a dramatic structural shift in North America. Technological advances, driven mainly by the opportunity to drill horizontal wells, have allowed shale gas and shale oil to be exploited in an economically viable manner. The process requires “fracking” the rock formation and pumping proppant to keep the cracks open for the hydrocarbons to be released.

Ceramic proppant is presently the best product on the market for this purpose on account of its strength and uniformity. Carbo is the world leader in the field with a 30% share of the global market and an almost 50% share of the North American market. The company is in the enviable position of boasting both the best product on the market, as evidenced by extensive performance data, and the best distribution network around, which allows delivery of its product directly to well sites. This is why Carbo has been virtually sold out of proppant for the past two years.

Five key factors are driving demand for ceramic proppant: 1) the growing percentage (now 80%) of wells being drilled horizontally (or directionally); 2) the growing number of frac stages per well, which has jumped from 3 to 30; 3) an increase in the amount of proppant used per stage; 4) more and more well results demonstrating that ceramic proppant use increases a project's internal rate of return (IRR); and 5) the greater number of rigs on the market drilling at faster speeds and over longer distances. To meet growing demand, Carbo has been expanding its production capacity in North America, which should vault to 1.8 billion pounds by yearend 2013 from 1.0 billion in 2009. This should add more than $2 per share in earnings over the next two years. Moreover, the company has decided to leverage its distribution infrastructure by also offering clients resin-coated sand, a high-quality tier-2 proppant. Total capacity for this product should reach 1.0 billion pounds by the end of this year, with sales expected to add more than $1 in EPS.

To be sure, such strong growth has attracted competition in the sector and others are expanding capacity as well. Having personally spoken with some of the company's clients, I know that most wish they could increase their allocation of Carbo proppant (Carbo has had to limit quantities to each client in order to ensure a diversified base) and that, in some regions, especially the Bakken shale fields of North Dakota, it was virtually impossible to obtain any Carbo proppant. While I do believe that the added industry-wide capacity will drag the price of ceramic proppant down slightly from its fourth-quarter high, I still think that Carbo will experience volume, revenue, and earnings growth thanks to its extra capacity.

In terms of valuation, I model the company growing its earnings from $6.00 this year to more than $10.00 in 2014. Over the 2010-2014 period, Carbo will invest more than $400 million to expand its production capacity and distribution infrastructure. Thanks to its exceptional cash flow generation, all this will be funded internally through operations, thus perpetuating the company's debt-free status. The stock was purchased at less than 10x earnings power, a real bargain for a debt-free company generating a return on capital of 20%.

I also started building a position in another stock during this first quarter. However, I will refrain from unveiling the name at this point in time as I am still mulling over the idea of increasing its weight.

There were two major sales in the quarter. First, **Wyndham Worldwide (WYN - $46.51)** was sold at a nice 50% gain less than six months from its purchase in August 2011. At the time, the market was applying competitors' multiples to Wyndham's *Lodging* segment (hotel franchisor) and *Exchange* segment and thus attributed virtually no value to the company's *Vacation Ownership* segment, the company's timeshare business. This segment had a book value of more than $2.2 billion and was profitable. By the time the stock was sold, the market was paying book value for this business. My intentions were to use the proceeds of the sale to invest in **Marriott Vacations Worldwide (VAC - $28.51)**, Marriott's spinoff of its timeshare business. The stock at the time was trading at less than 0.6x book value, that is, at a substantial discount compared with the Wyndham stock. Unfortunately, I was overly finicky about the buying price and ended up purchasing fewer shares than initially planned. The stock has since shot up 60%.

The other significant selloff in the quarter was **Indigo Books & Music (IDG - $8.85)**. The shares are trading at an irrefutably low multiple of 4x EBITDA as the future of the bookstore business continues to deteriorate. CEO Heather Reisman did well to begin rationalizing the number of outlets a few years ago and to invest early in the digital business with its Kobo e-reader. Kobo was sold to a Japanese company for $315 million in November. I think it was wise to sell the business at an attractive price; management knows how and when to monetize assets. Following the announcement of the sale, the Indigo stock price sprang 30% to $9.00. I sold our shares at just a tad above that mark. As good as management might be, they are facing hurricane headwinds from the digital revolution and the transition from physical books to e-readers. To quote Warren Buffett: “When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact.” Though I would not have thrown the Canadian bookstore business into that bucket five years ago, or even two years ago for that matter, I now believe technology has profoundly changed it forever.

## COMMENTARY

The philosophy at Tonus Capital is that the portfolio manager should enjoy the utmost flexibility in order to maximize returns. By being market-cap agnostic, we are free to uncover value wherever it lies. Interestingly, in the first quarter, the two stocks that contributed most to the portfolio’s performance were at opposite ends of the “size” spectrum.

On the large-cap side, **Comcast Corporation (CMCSK - $29.51)**, the largest position in the portfolio, did very well during the quarter, rising 25%. The company reported improved subscriber growth metrics and average revenue per user (ARPU), which boosted margins in its video segment. Moreover, late in 2011, the company announced it was selling its wireless spectrum to Verizon. As a result, it will no longer have to sustain massive capital investments to build its mobile business. In addition to avoiding the risk of developing a business where its competitive edge would have been limited, the company freed up liquidity, which management intends to use to pay out a higher dividend to shareholders (up 44%) and to repurchase $6.5 billion in shares (nearly 10% of shares outstanding).

On the small-cap side, **LoJack (LOJN - $3.97)**, up 30% during the quarter, was the second biggest contributor to the portfolio’s performance. The stock rallied when the company reported its fourth-quarter results and management provided guidance on 2012 profitability, which was generally in line with my model. The company will continue to benefit from strong new-car sales in the United States, which are expected to rise in excess of 10% to over 14 million from 12.8 million in 2011. Every half a million cars sold in the United States adds $1 million to LoJack’s EBITDA. I met with the new management team that took over in November and I believe they will focus on strengthening the company’s core auto business and might divest themselves of unprofitable operations. I also met with LoJack’s biggest client, its South African licensee, which confirmed the relevance of the company’s radio-frequency tracking device and reaffirmed its commitment to sell LoJack products. LoJack is still trading at 2x its depressed EBITDA but I believe there is still plenty of room for both profits and valuation multiples to improve.

Sincerely,

Philippe Hyn

Philippe Hynes, CFA
April 12, 2012

## Tonus Composite Performance Report

| Date | Tonus Composite Gross Return | S&P/TSX Total Return | S&P 500 Total Return ($CAD) |
|---|---|---|---|
| 1 Month | 3.52% | -1.63% | 4.82% |
| 3 Month | 10.04% | 4.39% | 10.51% |
| 6 Month | 22.42% | 8.14% | 21.10% |
| Year-to-Date | 10.04% | 4.39% | 10.51% |
| 1 Year | 14.35% | -9.76% | 11.69% |
| 2 Years* | 11.23% | 4.24% | 11.15% |
| 3 Years* | 14.22% | 15.59% | 14.30% |
| 4 Years* | 8.10% | 1.08% | 3.15% |
| Since Inception* (Oct. 31, 2007) | 7.20% | -0.83% | 1.23% |

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.*