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THIRD QUARTER 2017 - NEWSLETTER

Dear Partner,

We are pleased to send you this portfolio review and commentary for the third quarter of 2017.

Performance

During the third quarter of 2017, the TONUS PARTNERS FUND decreased -**0.47%**. 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 **2.11%**.

Year to date, the TONUS PARTNERS FUND is down **-0.62%** against **5.45%** for benchmark.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound rate of return of **11.41%**, compared with **7.02%** for the benchmark.

Quarterly review

The third quarter was a wild one for the Tonus Partners Fund, but ended with a basically flat return for the period. On the plus side, small caps woke up. For some time now, some of the smaller-sized stocks in the fund have been turning in strong financial/operational results, but investors have ignored their solid fundamentals. Market sentiment towards the category improved, particularly in September, and some of our holdings finally received the attention they deserved. This was the case for **Points International (PTS - $14.20)** and **Blue Bird Corporation (BLBD - $20.60)**, which both gained more than 20% in value over the past three months. Other stocks in the portfolio performed well, too. So much so that we would have closed the quarter ahead were it not for two factors: the unwarranted decline of a large position and, more importantly, the negative impact of the Canadian dollar's sharp appreciation.

Unwarranted decline of a large position

We first acquired **Uni-Select Inc (UNS - $26.96)** stock in 2013. Since that initial purchase, the share price has increased by a colossal 137%. As long-term investors, we look to outperform the market over <u>three to five years</u>. In that span, our holdings may suffer price declines in one or more quarters. Because ours is a concentrated portfolio, we invest in few stocks, but our investments in these tend to be big. When our largest positions have a poor quarter, it can have a material impact on the fund's <u>short-term</u> return. This was the case in Q3 as Uni-Select dropped 14%. Despite reporting good financial results, the company was dragged down when U.S. investors punished its American competitors for their poor numbers and for the risk they face in connection with Amazon entering their business. Though Amazon constitutes a real

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

threat in this regard, the market is overlooking the fact that Amazon is stealing market share in the do-it-yourself category, a category that accounts for less than 5% of Uni-Select sales (compared with 40% to 80% for its U.S. peers). We strongly believe in the business's earnings power and we are confident that its management's capital allocation will drive shareholder value skyward. When our investment thesis is unaltered, we want to acquire more at lower levels. This is why we followed the company CEO's example and bought more shares in September, increasing our position at very attractive prices.

A *fresh* new value investment

As value investors, we look for stocks that have temporarily fallen out of favour. We want to deploy our cash when few other investors are looking, i.e. when growth investors have thrown in the towel and valuations become more reasonable. This was the case late in Q3 with our investment in **Freshii (FRII - $5.61)**, the global franchisor of Freshii quick-service restaurants. We were able to scoop up shares at bargain prices after the company reset its long-term growth expectations in September. Freshii stock was a hot item when the company went public at the beginning of the year. By March, it had jumped to $15 from its initial share price of $11.50. At the time, analysts praised the attractiveness of the franchisor model, its trendy niche concept and its brisk growth. Of the nine analysts covering the stock, seven had a buy rating even when the stock was trading at a price-to-free cash flow multiple above 50x! Investors fell in love with the anticipated high-growth store count. Then, during Q3, management tempered expectations and the stock plunged 60% to under $6. While a franchisor/franchisee model is attractive from the standpoint of the low capital requirement it represents for the franchisor, it does carry the drawback of being at the mercy of franchisees deploying their capital. In this regard, management acknowledged that some franchisees were taking slightly longer to open new locations. Delays meant that a store count of 850 would be reached a little further down the road. In 2015, 77 stores were opened and, in 2016, 106 more. By our model, 100 stores should open in 2017 and 150 in 2018.

The market has completely given up on the concept even though the store count continues to grow at above 30% and same-store-sales remain strong. While it is definitely experiencing early growing pains, the company has not stopped generating plenty of cash. Nevertheless, the stock took a tumble and, at its current low price, only four of the ten analysts covering the stock today consider it a buy even though their average target price is still $9, which would translate into a 60% return! We, on the other hand, believe that we have acquired shares in a fantastic business concept with very little downside. The company's balance sheet is clean, with $1 per share of cash and no debt. By our model, the company's free cash flow per share should grow from $0.30 this year to $0.45 in 2019. At $5.60, we have paid a multiple of less than 10x (ex-cash) for a concept with multiple years of strong growth ahead.

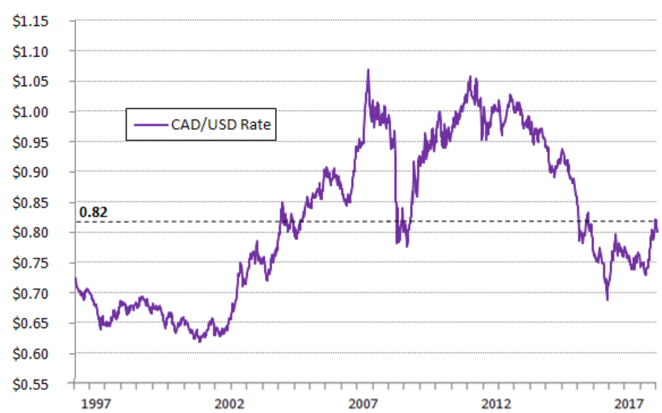
Sold shares

We were also active on the sell side as strong returns by some of our holdings led us to liquidate certain positions in full or in part. In this regard, our investment in **Points International (PTS - $14.20)** was sold at a good profit. It took longer than we originally expected for the market to recognize the strong free cash flow generated by its core business, but the stock finally rallied and, at 45% above its price low, we sold in order to channel the proceeds into more promising investments. We also liquidated our shares of **Tempur Sealy International (TPX - $64.52)**, realizing a 40% gain over the span of six months. We believe that the impact of the loss of the company's largest client will become fully visible in the second half of 2017 and that the resulting downside risk was not appropriately priced into the stock.

Negative impact of loonie's appreciation

We mentioned above that our quarterly performance was hurt by the CAD/USD currency swing. As you know, we invest on both sides of the border. We steer clear of calling short-term moves in foreign-exchange rates and base our investment decisions solely on the merits of the companies whose stock interests us. As illustrated in Graph 1, over the past 20 years, the CAD/USD rate has tended to mean-revert around 0.82. Given that the net asset value of our fund is priced in Canadian dollars, in the short term, we are exposed to currency variations. For example, if we buy one share of a U.S. company trading at US$100 when the CAD/USD rate is 0.74, our cost is $135 in Canadian dollars ($100/0.74). If at the end of the month the stock price remains flat but the Canadian dollar increases to 0.82 (which is essentially what happened this quarter), we would report a loss of 10% on this investment as the value of the share would be down to $121.95 in Canadian dollars. A rising loonie makes U.S. goods cheaper: it makes online purchases on U.S. sites cheaper, but it also lowers the value of foreign investments. When the U.S. dollar appreciates, we benefit. This was the case in 2011, 2013, 2014 and 2015. But since the fund's launch in January 2016, the U.S. dollar has been a drag on our returns. This year, the fluctuations have been significant: the U.S. dollar declined against the loonie 1% in May, 4% in June and 4% in July, resulting in a year-to date drop of 7%. If only a small portion of our holdings was in the United States, the impact would be immaterial. However, given that our <u>portfolio's U.S. exposure has averaged 68.6%</u>, we feel the full brunt of the greenback's deprecation. This is why foreign exchange movements had a **-5% impact** on the fund's year-to-date returns. Our performance this quarter would have been positive had it not been for currency moves.

<u>Graph 1:</u> **Historical CAD/USD Exchange Rates (20 years)**



Patience

With volatility still non-existent and markets holding at high levels, there are few opportunities to be had by value investors like us. Markets worldwide have been climbing slowly and steadily, so much so that, for the first time in 30 years, in the first nine months of the year, there has not even been a 5% pullback in either the S&P500, the MSCI Europe or the MSCI Asia. The North-American economy is performing fine and earnings are up, but so are valuations, which is what matters most to us. High valuations typically mean that future gains have been pulled forward. In such a context, we must remain patient and wait for the right opportunities to come along before investing your capital.

Sincerely,

Philippe Hynes, CFA
October 15, 2017

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

Tonus Composite Performance – As of 09/30/2017

	Tonus Composite (Gross Returns)	*Index*
3 months	-0.47%	2.11%
6 months	-2.13%	1.45%
YTD	-0.62%	5.45%
1 year	4.48%	10.93%
2 years	13.67%	12.30%
3 years	8.17%	9.68%
5 years	14.94%	13.76%
Since Inception	**11.41%**	**7.02%**

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.