TONUS CAPITAL INC.

Tonus Capital Inc.
999 de Maisonneuve Ouest
Suite 799
Montréal, Québec H3A 3L4
Tel: (514) 844-4443
www.tonuscapital.com

FOURTH QUARTER 2019 - NEWSLETTER

Dear Partner,

Herein our portfolio review and commentary for the fourth quarter of 2019.

Performance

During Q4, the Tonus Partners Fund registered a gross return of **7.78%**. 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 **4.95%**.

For 2019, the Tonus Partners Fund is up **3.52%** against **23.75%** for benchmark.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved an annual compound rate of return of **8.72%**, compared with **7.80%** for the benchmark.

Quarterly review

Our portfolio closed the year on a high note, climbing 8%. Had it not been for the decline in currencies, our performance in the fourth quarter would have come close to 10%. Most of our names delivered good financial results; many saw their share prices shoot up substantially as a result. The quarter culminated with a foreign buyer reaching a deal to acquire Cineplex at a juicy premium.

We laid out our thesis for investing in **Cineplex Inc. (CGX - $33.85)** in our previous quarterly letter. We contended, based on a sum-of-parts analysis, that its theatre business alone was worth at least $20 and that we were getting its media and entertainment businesses for free. It seems that we were not the only ones taking this angle. In December, Cineworld, the second largest cinema chain in the world, made an offer to acquire the company. We plan to vote in favour of the acquisition as the $34 per share offered is just above our estimate of the fair value of the company. This would represent a 49% return on our investment after only six months, given that we bought at the net price of $22.87 back in June.

Recess is over, back to class

The fourth quarter saw us return to a sector that has been profitable for us in the past: education stocks. We had been out of the industry for many years, as major reforms initiated under the

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

Obama administration had put a dent on profitability in the sector. Earnings growth had previously been driven by rising tuitions fees—an unsustainable model. Changes were needed to weed out the bad actors. Laws were enacted, and successful institutions are now working within these new guidelines where increased profitability comes from rising enrollment—a more sustainable model. Under current regulations, the best institutions can operate profitably, offering quality education to students while generating a high return on invested capital for investors.

That said, education remains a popular political topic and it has resurfaced during the race for the Democratic presidential nomination. The entire sector recently tumbled following comments by some candidates to the effect that they would make higher education free. This scenario being highly unlikely, we took advantage of this volatility to invest your capital in two well-run institutions.

First, we invested in **Strategic Education (STRA - $158.90)**, which sprang from the merger of two universities: Strayer and Capella. With its innovative structure allowing students to use online tools to complete their degrees at their own pace and convenience, STRA has enjoyed a strong increase in the number of working adults seeking to obtain a post-secondary degree. This combined with cost synergies from the merger will drive profit growth.

Second, we took a position in **Grand Canyon Education (LOPE - $95.79)**. In the past decade, LOPE has invested more than $1 billion to build an on-campus and online technological platform that currently supports more than 100,000 enrolled students. Recently, management decided to separate the university from its back-office operational backbone. This new structure will allow LOPE to leverage its infrastructure to support other universities that might want to take advantage of their strong operational capabilities.

Under our modelling, earnings per share should grow at more than 15% for both institutions. We bought at multiples well below where the shares had been trading for the past two years. As both companies have pristine balance sheets with no net debt, we believe that our downside risk is limited and that profit growth will push their stock price up.

Review of our capital deployment in 2019

We bought six new stocks in 2019. All are up from our purchase price, by 25% on average. You can refer back to our 2019 quarterly letters for a description of our investment thesis for each of these.

We also significantly increased our position in three stocks that declined on account of what we believed to be transitory issues. First, the share price of **Premier Inc (PINC - $37.88)**, the manager of a healthcare group purchase organization, went down following a negative report by a hedge fund. We covered this is our previous letter. The stock was up 30% in Q4.

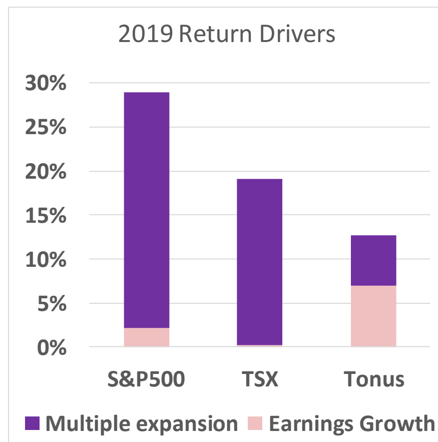
Second, **Blue Bird Corporation (BLBD - $22.92)**, the school bus manufacturer, had to revise its profit growth expectations down early in 2019 after being hit by the quick increase in steel prices. Investors failed to see this was just a temporary price hike. Bluebird used this excuse to up its prices. The stock reacted well late in the year as profits were in line with expectations and were projected to grow by 15% to 20% in 2020. The stock is up more than 20% from when we increased our position.

Third, **Houghton Mifflin Harcourt (HMHC - $6.25)**, a publisher of K-12 education solutions, had trouble convincing investors that its $100-million free cash flow level was sustainable beyond 2019. Although the stock was up 17% in Q4, it closed the year at the same price that we bought our additional shares at earlier in the year. We believe that another year of high free cash flow, balance sheet deleveraging, and margin expansion will draw investors back to the stock in time, pushing it closer to what we think is fair value; a nice premium above today's levels.

Why did markets go up this year?

Simply put, stock prices are influenced by two variables: earnings and the valuation multiple (how much investors are willing to pay per dollar of earnings). Earnings are a pretty straightforward matter. The ultimate business success, from an investor's standpoint, is profit growth. However, the value of a business can also rise if its multiple goes up. You can think of this as the price tag investors place on future earnings. The more promising the future looks, the more that investors will be willing to pay, spurring the price up.

So what drove the 20% market return in 2019? As we can see from the graph, earnings actually grew very little in both Canada and the United States in the past year. Consequently, today's higher stock prices are explained entirely by multiple expansion. This means that investors are now willing to pay 20% more for the exact same business!



There is one factor behind this risk-on approach: interest rates. The U-turn in monetary policy once again benefitted growth stocks. They outperformed value stocks by an astonishing 11.2% this year.[2]

With interest rates already at rock bottom levels, future improvement in stock prices will have to come from earnings growth. This is where our value focus lies: finding companies whose multiple should not decrease much from current levels while their profitability improves. At year-end, our portfolio included many companies that registered better profitability, yet the average multiple for our names increased much less than the market's did. As a result, we are starting 2020 in an enviable position, with our portfolio trading at 14x forward earnings, which is much lower than market multiples.

Our full-year performance

Although the final quarter of the year was good, 2019 as a whole was disappointing. First and foremost, our performance was negatively impacted by a couple of stocks that declined significantly following weak financial performances. The hit was magnified by the fact that both were large positions.

That said, when we compare ourselves against the market in general, it is important to remind you of some of the specific characteristics of our investment style that make our yearly numbers differ from those of general indices.

[2] Based on the Russell 3000 index, which covers 98% of all U.S incorporated equity securities.

First, we favour a value approach and, as previously explained, value stocks again significantly underperformed growth stocks in 2019. While value has historically outperformed growth over the long term, value has lagged growth in 12 of the past 13 years.

Second, our portfolio is heavily concentrated in small- to mid-cap companies (market capitalization of $200 million to $10 billion). Small caps have lagged large caps by 8% over the past 12 months. Over the long-term though, we believe small-cap value stocks represent a great place to find misunderstood and/or undervalued investment opportunities.

Third, we have the flexibility to hold on to cash. In an environment like the one of late, however, not only has this flexibility earned us very little, it has also kept us disciplined in selling off fully valued stocks. Unfortunately, some of the names that we sold by remaining true to our approach kept going up in this bull market. Our portfolio's cash position averaged 20% this past year. Needless to say that it was a drag on our numbers.

We cannot predict exactly when the current trend of risk-on mega-cap growth stock over-performance will end. What we can do is stick with thinking like business owners; investing your capital wisely in good companies temporarily trading at a discount.

Looking forward to 2020

We believe that the positive momentum with which 2019 ended will carry over into 2020. We are entering the New Year with optimism. We believe that our portfolio contains many stocks that are deeply undervalued, much like Cineplex was. Our value investment thesis for Cineplex played out perfectly. However, we cannot count on an outright acquisition to quickly realize the inherent value of all of our holdings. Consequently, we must remain patient. It is our firm belief that investors are rational and that they will ultimately reprice many of our undervalued assets more fairly.

Sincerely,

Philippe Hynes, CFA
January 13, 2020

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

Tonus Composite Performance – As of 12/31/2019

	Tonus Composite (Gross Returns)	*Index*
3 months	7.78%	4.95%
6 months	5.21%	7.82%
1 year	3.52%	23.75%
2 years	-4.37%	9.79%
3 years	-2.00%	10.32%
5 years	4.44%	10.16%
10 years	10.21%	11.32%
Since Inception	**8.72%**	**7.80%**

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.