TONUS CAPITAL INC.

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

FIRST QUARTER 2022 - NEWSLETTER

Dear Partner,

Here is our portfolio review and commentary for the first quarter of 2022.

Performance Review

During the first quarter of 2022, the TONUS PARTNERS FUND registered a gross return of **-3.8%.** Over the past twelve months, the Fund achieved a gross return of **-0.8%.**

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compounded gross rate of return of **9.4%**, compared with **8.2%** for the benchmark[2].

Portfolio Review

Our fund suffered a slight pullback in the first quarter of the year. Most of it was attributable to our exposure to consumer discretionary stocks, a sector weighed down by the risk of an economic slowdown. Nevertheless, we came out of the period having dodged the bigger setbacks registered by many popular stocks. U.S. large- and small-cap indices recorded declines of -4.9% and -7.2%, respectively, and their performances would have been even worse had it not been for the spectacular 40% return on energy stocks in Q1. This sector, which is practically absent from our portfolio, alone added 1.0% and 1.7% to the S&P 500 and Russell 2000 indices, respectively. Its impact was even more pronounced in Canada. Commodities, roughly defined as energy and materials, added 5.9% and 9.7% to the returns on large and small caps, respectively, erasing broader declines in other sectors (see figure 1).

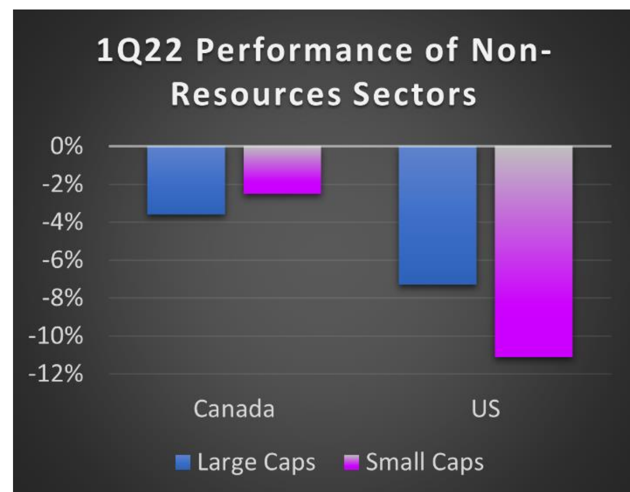

Figure 1

Given that our portfolio is not exposed to these cyclical and lower-quality sectors, we find it more informative to compare our performance on an apples-to-apples basis by stripping out the volatile energy sector. Thus, while our blended benchmark dipped 1% in the quarter, the ex-energy counterpart was down more than 6%.

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

[2] Please see page 4 for a description of the benchmark

The year started off with concerns about tight employment markets and stretched supply chains, two factors that threatened to drive up inflation. As we mentioned in our [previous letter](), we were sitting on above-average cash levels because stocks whose profitability expectations and valuation incorporated these input cost pressures were hard to come by. A few weeks later, the war in Ukraine broke out and the sanctions on Russia have had a substantial economic impact globally. The cost of raw materials has risen at a faster pace. This is true not only for oil and gas but also for various commodities and agricultural products. While the strong pressure from many of these will subside eventually, in the meantime, it comes as no surprise that prices are going up as companies try to pass on higher input costs. Consequently, inflation has reached levels unseen since the early 1980s and central banks have no choice but to accelerate the pace of interest-rate hiking.

In this far-from-ideal environment, profit margins will narrow, disposable income will decline, and borrowing costs will increase. As a result, investors must assess what has already been priced in. For instance, **small caps plunged in January as they underwent a -20.9% correction** from their November level. The Russell 2000 index of small-cap stocks is trading 13% below its median multiple. Excluding its very expensive top-10 stocks, the S&P 500 index is trading at a P/E ratio equal to its 25-year historical average. Current multiples have not exactly hit rock bottom, but it is a fact that they have come down significantly from their peak.

Playing offence with inflation

Once a broad short-term decline in margins materializes, we will focus on factors that signal whether they, along with sales, might swing upward again. Our return will rest on the ability of our portfolio companies to earn more without having to increase their spending heavily. Little to no use of financial leverage (debt) has always been part of our investment philosophy. If cheap leverage dries up, then companies with an established asset base and desired products will do well in an inflationary environment.

Such companies have historically fared well in inflationary periods. **Dollarama (DOL - $70.90)** is a case in point. They have thrived in times of rising costs by adjusting prices rapidly when demand grows from stretched consumers trading down. Our notes from our December 2018 meeting with management were as follows: *Dollarama to outperform and grow same-store-sales much faster when inflation pressures finally force competitors to raise their prices*. This is finally happening now, and DOL is taking advantage of the situation to introduce items at a new price point of $5, something investors have been waiting for since 2016. They recently guided to same-store-sales growth of 4% to 5% this year, a number we feel is very conservative. DOL has been one of our best performers this year.

During the quarter, we also made the acquisition of a new stock that will benefit from inflation. We bought shares of **Hillman Solutions (HLMN - $11.88)**, a distributor of hardware, home improvement products and personal protective equipment. Their field and service teams are responsible for sourcing and managing inventory in order for fill rates to remain elevated at their big-box hardware store partners (Home Depot, for example). Last year was challenging for them as inflation pushed their costs up a whopping $175 million and supply-chain bottlenecks doubled lead times to +200 days for products arriving from Asia.

Despite all this, they managed to grow sales for the 56th time in 57 years, reduce their leverage, and implement price increases to offset higher costs. After raising prices 15% last year, they completed another round of hikes in March 2022 without their retail partners pushing back. In the

short term, these are merely enough to cover rising costs, but they confirm Hillman's strong business model. Though they will have no impact on earnings this year, the higher prices are there to stay and will boost profits when things get back to normal. The stock price should react accordingly!

To sum up regarding inflation, there is no doubt that it will play a major role this year. On the one hand, it will increase the value of hard assets owned by companies and, as price increases are broadly accepted, will fuel sales growth. On the other hand, costs are rising and likely rising faster than prices are, which is resulting in profit margin erosion. Consumers might reduce discretionary spending in the face of higher prices for many essentials and interest rates will go up, reducing credit and liquidity in the system.

After analyzing the potential impact on the short- and long-term value of our investments, we expect inflation could negatively impact six of our holdings. In each case, their respective stock price has already suffered of late and we believe, barring much worse inflation data later this year, that most of the negative pressure is already priced in. However, it is not all doom and gloom. On the flip side, we believe that eight of our stocks will be able to jack their prices to offset higher costs.

As you might well imagine, inflation is at the heart of conversations we are having with various management teams. The volatility it brings to short-term profitability could serve us well with our long-term investment horizon. In recent times, thanks to low interest rates, unprofitable business models that cropped up in recent years have hardly been penalized for failure. Many of these businesses might not retain a customer base long enough or might not attain profitability without continued low-cost financing. Given that our investing philosophy includes taking account of such possibilities and likelihoods, we expect a certain degree of insulation at the portfolio level and it remains front of mind when evaluating stocks.

Patience rewarded

One holding exited the portfolio in Q1. **Houghton Mifflin Harcourt (HMHC - $21.00)** received a takeover offer from a private equity firm. We believe they saw the same positive drivers as we did: a massive influx of funding from the federal government, a shift in school board spending from COVID protection equipment to education material, and the shift to digital learning. The $21 offer represented a 36% premium on the price at the time and a **184% gain on our $7.39 book value**. Our ride up with HMHC was not exactly a smooth one. The stock initially dropped far below our original purchase price as textbook spending by a few major states was delayed. However, as the original reasons driving our purchase still held and following numerous discussions with the management team to understand their vision and strategy, we ended up buying more shares at lower prices, thus reducing our average cost. It turned out to be a successful investment.

Environmental, Social, and Governance (ESG)

Over the past year, our team has paid greater attention to the ESG criteria governing our investments. We completed a thorough review of each of our holdings, engaged with management teams, and actively exercised our voting rights at annual general meetings. Given the recent developments with HMHC and for you to better understand our ESG approach, we have made this internal report available on our website. In general, we scored HMHC slightly above average. We were pleased with their focus on increasing the usage of recycled/FSC paper in addition to pushing their digital solutions. We applauded this move and pushed management

to give us more details on this transition; not only is it great for the environment (reducing paper usage and transportation impact), it is also margin accretive and suitable for recurring subscription revenues. Moreover, we were enthused by the significant number of books they donated to charitable organizations.

On the negative side, one of the points raised with senior management was the low diversity among its workforce and management team. We believe that it is crucial for the material presented in textbooks to reflect society, seeing how this material is a cornerstone of children's education. We pressed that having a workforce that is more representative of the ethnic diversity in North American society would help this purpose. If you would like to discuss our ESG initiatives and our approach, please let us know.

In closing, let us hope that there will be a quick end to the war in Ukraine. Our team is making donations to this cause and, in addition, a member of the team and his family are preparing to host a Ukrainian family should the need arise.

Sincerely,

Philippe Hynes, CFA
April 14, 2022

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

Tonus Composite Performance – As of 03/31/2022

	Tonus Composite (Gross Returns)	*Benchmark*
3 months	-3.8%	-0.6%
6 months	-5.6%	4.8%
1 year	-0.8%	11.6%
3 years	11.0%	14.2%
5 years	4.1%	10.3%
10 years	10.2%	11.5%
Since Inception	**9.4%**	**8.2%**

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.