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SECOND QUARTER 2018 - NEWSLETTER

Dear Partner,

We are pleased to send you this portfolio review and commentary for the second quarter of 2018.

Performance

During the second quarter of 2018, the TONUS PARTNERS FUND increased **4.49%** (gross of fees). 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 **6.12%**.

Year to date, the TONUS PARTNERS FUND is down **-0.88%** against **4.80%** for benchmark.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound rate of return of **10.84%**, compared with **7.53%** for the benchmark.

Quarterly review

After a disappointing first quarter, our portfolio posted a strong gain of 4.5% in Q2. Year to date, the Canadian market is relatively flat and the U.S. market is up slightly (+2.6%) due entirely to the performance of the same five trendy tech stocks (Amazon, Apple, Facebook, Google, Microsoft). As I write these lines, our portfolio, too, is slightly up from the beginning of the year as we push back against the negative current in our preferred sectors.

We mentioned in our last letter that we had taken advantage of heightened volatility earlier in the year to invest a significant portion of our cash reserves. This proved timely, as the majority of these purchases have since generated good profits. We also indicated that we felt the portfolio's valuation was appealing. Some of our attractively priced holdings registered double-digit returns in the quarter. That said, the sharp jump we expected from two of our larger positions has yet to occur. We believe our patience could be well rewarded in the second half of the year in light of the fact that their valuations remain very attractive. Stay tuned for developments in this regard.

Trade dispute

Most of our research time is spent analyzing companies in terms of financial performance and future prospects. However, given the current geopolitical environment, we cannot in good conscience invest without taking account of macroeconomic forces as well, especially regarding

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

trade tensions between the United States and, well, everyone else. Though their direct impact on the economy is likely to be limited in the short term, tariffs could have repercussions by disrupting the global supply chain many companies rely on. In light of this, it is imperative that we assess the impact of trade on our holdings' top-line growth and profitability. From a sales perspective, our small-cap bias is a definite plus, as smaller companies tend to focus more on domestic markets and are less exposed to exports. Only a couple of stocks in our portfolio could be negatively impacted by diminished exports. From the standpoint of profitability, however, trade restrictions and tariffs entail additional costs that must be borne by either the manufacturer or the consumer. We are integrating this factor in our detailed financial models and adjusting forecasts, fair value, and target prices for all of our investments in order to assess their attractiveness more accurately; a testament to the proactive valuation of our holdings.

As we have stated in the past, uncertainty generates volatility, which in turn breeds opportunity. We are poised to benefit from market instability. We are conducting due diligence on stocks that could suffer unduly from headline risk. If investors dump these and the stocks reach levels where all bad news, and more, is priced in, we will be ready to take advantage of the market's inefficiencies.

Value investing

This is what value investing is all about. To quote renowned value investor Seth Klarman:

> ***"When all feels calm and prices surge, the markets may feel safe; but, in fact, they are dangerous because few investors are focusing on risk. When one feels in the pit of one's stomach the fear that accompanies plunging market prices, risk-taking becomes considerably less risky, because risk is often priced into an asset's lower market valuation."***

Investing in the stock market is an inherently risky proposition, as there is no guarantee as to where a security's price will go. However, value investors manage this risk by buying stocks at prices that limit their downside. For every company, no matter how good or bad its business model, there is a price at which it becomes a buy (all bad news is priced in and future potential is ignored) and a price at which it becomes a sell (all good news is priced in and future risks are ignored).

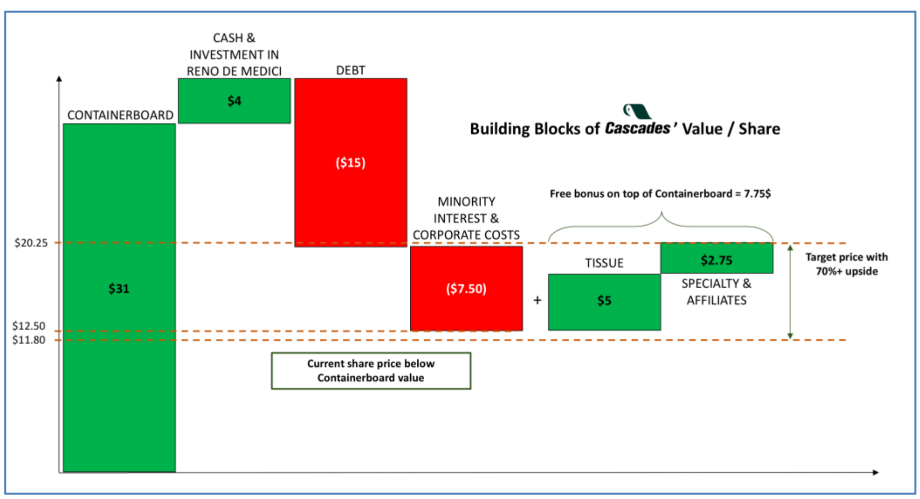
Value investing is about finding high quality bargains. When looking to buy a consumer item, such as a TV, you get more for your money if you wait for a discount or a sale instead of paying full price. This, in a nutshell, is our game plan: We wait for stocks to be on sale, that is, to trade below our assessment of their intrinsic value, before we purchase them.

In times of panic and volatility, market participants tend to focus more on risks and ignore opportunities. This drives prices down. Though it may seem counterintuitive, when prices plunge, there is actually **less risk**, given that negative factors are priced into the stock and the odds of further decline are diminished. That is when we want to be active (as was the case in Q1), that is when bargains can be had. Most of our value purchases carry a small potential loss, as most of the price decline has already taken place (most of the risk is priced in), and the promise of a decent long-term potential gain, once investor apprehension abates and the stock's discount to intrinsic value wanes. It then becomes a waiting game, as there is no predicting when investors will once again embrace the stock. However, as our downside is quite limited, risk becomes the opportunity cost of prices treading water for an extended period of time.

A prime example: Cascades

We came across such a value stock (low downside risk, good long-term prospects) in the second quarter: **Cascades (CAS - $11.77)**. Many of you will recognize the name, but many of you will also incorrectly identify Cascades primarily as a paper and boxboard producer. Actually, it has streamlined its operations over the past five years, selling off its specialty paper business and its 17% ownership in renewable energy developer Boralex. It has also increased its share of value-added converted products (ranging from bulk sales to finished products) from about 55% to over 70%. Its two main segments are now containerboard packaging and tissue production; half the profits used to stem from the latter, 80% now come from the former. This is a backdoor play into the rapidly growing e-commerce sector. Its share price stood north of $18 a year ago and is now south of $12, a drop of 35%.

Why do we think further downside is limited? The majority of the share price decline has been due to difficult market conditions in the tissue segment (toilet paper and paper towels). While this segment generated $150M in EBITDA for Cascades in 2016, it will likely earn less than $60M this year owing to a steep hike in the cost of raw materials, namely, virgin pulp (+30%). Though Cascades management has made smart strategic capital allocation choices in the past, investors dislike their somewhat contrarian decision to invest more than $250 million in this segment to increase quality, volumes, and conversion rates. With operating margins now close to nil for all players in the industry, we believe market conditions cannot get much worse, which means that the stock cannot come under much more pressure. In our downside scenario, assuming that the stock will derive no value from this segment, we still believe we can reap a good return from this investment.



Today, 80% of the company's profits come from its containerboard packaging division, which enjoys a 32% market share in Canada and constitutes the 6th largest producer in North America. This segment presently enjoys fantastic market conditions driven by three factors. First, demand is very strong on account of the growth in e-commerce and the ensuing demand for boxes. Second, the industry is currently operating at full capacity (98.5% in May) and, though capacity is to grow by about 1.8%, this will be outpaced by an expected 3.5% growth in demand. These are ideal conditions for prices to rise (+8% this year). Third, contrary to the majority of the players in the industry, Cascades does not use virgin fibre as raw material. Instead, it enjoys a significant competitive advantage in that its plants are outfitted to use recycled fibre as input. The price of virgin fibre is up this year; the price of brown recycled fibre is down more than 60% from its peak. The combination of higher prices, lower costs, and higher conversion rates will translate into a jump in profitability of more than 60% this year! As there are more profits to come, we believe investors are failing to recognize the full value of this business unit.

Our sum of the parts valuation shows our position in Cascades to be a value investment. Under our downside scenario, where we assign <u>zero value</u> to its tissue operations and a sub-industry-average multiple to its containerboard segment, we still arrive at a fair value of $12.50 per share, which is slightly above the current price. Under what we believe to be more realistic assumptions, we see an upside of more than 70% on our investment, provided e-commerce demand for boxes continues to grow and tissue earnings equal their cost of capital. This would be driven by tissue margins expanding, albeit at a lower level than prior peak, as virgin pulp prices come down and/or tissue prices go up. In sum, we believe the prospective return to be a hefty one relative to the risk (potential loss) we are taking.

VALUE / SHARE $	EXPECTED	DOWNSIDE
CONTAINERBOARD	$31	$30
TISSUE	$5	$0
RENO EQUITY + CASH	$4	$3
SPECIALTY + AFFILIATES - CORPORATE - MINORITY INTEREST	($4.75)	($5.50)
DEBT	($15)	($15)
(=) PRICE TARGET	$20.25	$12.50

We will continue to be on the lookout for more investments of the sort in the months ahead. Until our next letter, we wish you all a very pleasant summer.

Sincerely,

Philippe Hynes, CFA
July 10, 2018

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

Tonus Composite Performance – As of 06/30/2018

	Tonus Composite (Gross Returns)	*Index*
3 months	4.49%	6.12%
6 months	-0.88%	4.80%
YTD	-0.88%	4.80%
1 year	2.15%	13.04%
3 years	8.12%	10.35%
5 years	10.51%	13.78%
10 years	11.76%	8.56%
Since Inception	**10.84%**	**7.53%**

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.