● TONUS CAPITAL INC.

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SECOND QUARTER 2021 - NEWSLETTER

Dear Partner,

We are pleased to send you our portfolio review and commentary for the second quarter.

Performance Review

During the second quarter of 2021, the TONUS PARTNERS FUND gross return was **7.9%**. Year to date, the Fund achieved a gross return of **19.5%.**

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound gross rate of return of **10.6%**, compared with **8.29%** for the benchmark[2].

Portfolio Review

We are pleased to report another solid performance in the second quarter. Our fund gained 6%, lifting its six-month return north of 16%. This was accomplished over a quarter that was much quieter than the corresponding period last year, for both us and the markets. Whereas half of the trading days in 2Q20 had fluctuations greater than +/- 1.5%, only two days did this year. Economies continued to reopen in the developed nations and most industries were back at or above pre-pandemic levels. As a result, all sectors posted positive returns in the first half of the year. Benefitting from this momentum, our fund outdid the markets. Its return would have surpassed 20% had it not been for the decline of the U.S. dollar. Its 1-year return topped 54%.

Sales and earnings are growing

As mentioned in our last letter, the fast pace of corporate profit growth has been the locomotive pulling markets forward. In our opinion, this train will not be stopping anytime soon. Since the beginning of the year, the 2021 sales and earnings forecasts for the S&P500 constituents have been revised up 5% and 16%, respectively. Except for three stocks, all our holdings have projected earnings at or above the level expected at the start of the year. The situation is heartening, but it is no reason to break with our cautious approach. We would be getting ahead of our skis if we assumed that all hazards have vanished. The outlook is certainly favourable, but some risks remain on our radar.

First, costs are rising. In May, the Consumer Price Index showed the strongest year-over-year reading since 2008, and the core inflation index popped the most since 1992. Wages are likely to continue to climb given the tight labour market. On top of additional costs, some companies are having to curb production or reduce their service offering owing to labour shortages.

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

[2] Please see page 4 for a full description of the benchmark along with its historical returns

Second, companies are being challenged by the extremely tight global supply chain. Vessels are fully booked, leaving many companies stranded at the docks. Those that secure spots must accept paying the skyrocketing container shipping costs. These two factors—rising costs and delayed output—could throttle expected profitability. We are analyzing each of your investments and positioning the portfolio such as to minimize potential short-term risk while keeping a steady eye on long-term value creation.

SPAC: Special Purpose Acquisition Company

Though markets have been less volatile of late, speculation has not abated. Many stocks continue to fluctuate based on momentum rather than fundamentals. Speculation is also what is driving the SPAC boom. SPACs are also known as blank cheque companies. They are shell entities that raise money to target private companies and take them public. Shockingly, speculators will pile into these securities and drive up their share price up before any transaction has even been announced! When a deal is struck, oftentimes little financial data are provided, making the process of bringing these companies public much less transparent. Consequently, investors must dig deeper to conduct their analysis. Seeing how SPACs are extremely popular with speculators, we doubt many of them have conducted their own proper financial evaluations. The riskier the business model seems to be, the higher SPAC shares seem to fly. This is what happens until the target company starts reporting regular quarterly profits or, as is often the case with SPACS, quarterly losses. Only then do investors get a clearer picture of what they got into.

Take the example of Lordstown Motors, a company that plans to develop a light-duty electric truck. Though it has yet to build its first prototype, the company fetched a $5-billion valuation earlier this year. In the past month, both its CEO and its CFO quit after the company disclosed that it might not have sufficient funds to begin production and that it might not be able to continue as a going concern. The stock is down 54% year to date. In our opinion, while not all SPACs will necessarily turn out this way, we do expect them to remain very volatile investment vehicles. Since some SPACs actually target profitable companies, this may present us with enticing entry points to buy shares of sound businesses that are not yet fully understood and mispriced by the market.

We were able to add two of these in the second quarter. The first was **Whole Earth Brands (FREE - $14.50)**, a company providing access to high-quality plant-based sweeteners and flavour enhancers. They offer products to consumers seeking alternatives to refined sugar. Through the combination of three companies, Whole Earth now has the scale to increase penetration in its core U.S. market and to expand distribution internationally. Sales should surpass the half-billion-dollar mark this year and the company is poised to benefit from the secular shift towards health and wellness. While this category grew 10% last year, the company's brands grew at twice that rate, gaining market share over competitors. All this was accomplished with limited distribution in the nation's largest retailer. Possible entry on Walmart shelves later this year would further accelerate brand expansion. Moreover, as Whole Earth completed their latest acquisition only in early 2021, they are presently in the process of optimizing distribution and manufacturing in the aim of improving operating profits by 5 to 10 million dollars. We bought shares at a multiple of less than 9x forward EBITDA, a very attractive entry point.

Second, we bought shares of **ARKO Corp. (ARKO - $9.19)**, a convenience store operator in the United States. As long-time owners of Couche-Tard, we are well acquainted with this industry and its growth-through-acquisition business model. Arko's network has grown from

1,000 sites five years ago to more than 3,000 today, making them the 6th largest player in their category. Unlike larger consolidators, Arko can look for smaller targets that they can buy at more attractive multiples (on average they have paid 6.6x EBITDA). Through aggressive synergy extraction, they have historically been able to cut that multiple by half, earning them a return on capital above 35%. In addition to making deals, we expect the management team, which owns 38% of the outstanding shares, to deploy capital wisely to remodel 360 sites in the aim of increasing margins and profits. The stock is currently trading at a 20% discount to larger peers, though its growth prospects are more attractive, thus making the price very appealing. With the stock recently joining the popular Russell 2000 index, we expect more investors will pay attention to its great results.

We say goodbye to Photon

During the quarter we saw one of our holdings be acquired by a large player. Although we never buy companies on the premise that they will be taken over, this is always a possibility, especially for smaller-cap companies. We purchased stock in **Photon Control (PHO - $3.58)**, a manufacturer of optical sensors used to measure temperature and position, in October 2020 when it was trading at $1.62. Photon's main customers are semiconductor equipment manufacturers. As demand for electronics grew, so did demand for Photon sensors. After other investors took notice of what our analysis had concluded earlier, a larger player in the market, MKS Systems, offered to buy the stock at $3.60. This is a fair price for the company and offers us a fantastic return over a very short period of time.

A new initiative at Tonus

There has been a growing movement within the investment industry over the past few years to focus more on ESG, that is, environmental, social, and governance factors. Analyzing these factors enables investors to know companies better and forces companies to improve some aspects of their business. At Tonus, where we conduct our own fundamental research, these issues have always been taken into account in our analyses. Still, we have decided to take this matter a step further to gain an even better understanding of current and prospective investments.

To this end, in partnership with Concordia University, we have welcomed Brandon Mundl to our team. His main task will be to conduct ESG analysis for us. Numerous funds use third-party ESG scores to obtain rankings that might ultimately determine whether a company is an acceptable investment. Rather than rely on someone else's research, we prefer to do our own. In addition to assessing whether a company is aligned with our ESG values, such research will also help us identify potential financial risks related to these factors. Brandon becomes the fourth member of our research team. Our efforts continue to be centred on finding North American stocks offering good upside potential with a risk profile that meets our stringent standards.

Sincerely,

Philippe Hynes, CFA
July 6, 2021

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

Tonus Composite Performance – As of 06/30/2021

	Tonus Composite (Gross Returns)	*Index*
3 months	7.92%	6.87%
6 months	19.52%	15.93%
1 year	54.49%	41.56%
3 years	9.76%	12.23%
5 years	8.84%	12.71%
10 years	12.97%	11.12%
Since Inception	**10.60%**	**8.29%**

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.