TONUS CAPITAL INC.

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THIRD QUARTER 2016 - NEWSLETTER

Dear Partner,

We are pleased to send you this portfolio review and commentary for the third quarter of 2016.

PERFOMANCE REVIEW

During the third quarter of 2016, the Tonus Partners Fund increased **7.69%**. 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 **5.24%**.

Year to date, the Tonus Partners Fund is up **18.87%** against **8.72%** for benchmark.

Since the inception of the Tonus Composite in October 2007, it has achieved a compound rate of return of **12.22%**, compared with **6.59%** for the benchmark.

The quest for yield

The third quarter was a great one for the Tonus Partners Fund as it registered a strong gain of 7.7%. Year to date, despite the negative pressure the U.S. currency bore on our returns, the fund was up 19%, compared with 9% for North American indices. After declining sharply at the beginning of the year, the markets bounced back with consecutive positive monthly returns from March to September. Scrambling to find alternatives to low- or even negative-yielding bonds, investors have been shifting their money to sectors of the stock market that provide what used to be a generous yield, namely, utilities, real estate, and telecoms. To attract income-seeking investors, companies with no or negative earnings growth have been boosting their dividends with borrowed funds. In light of this, we remain cautious on some sectors of the stock market for two reasons. First, many yield investments are trading at very high multiples, a price we are not willing to pay. Second, it is particularly troublesome for us that these valuations have continued to rise despite the fact that interest rates have very little room to decrease further and thus increase the value of the yield. In fact, investors are anticipating only one fed rate hike in the next two years! In such a context, the unappealing risk/reward ratio does not justify chasing yield. If we cannot find stocks trading at a significant discount to their intrinsic value, we will place your cash in bankers' acceptance notes paying a "generous" yield of 0.77%.

Leveraging our research

Meanwhile, most of our stocks performed well in the period. One company we want to highlight is **MiX Telematics (MIXT - $6.39)**, a global provider of fleet management, driver safety and vehicle tracking services. This is a good example of leveraging our research to find new ideas. As you know, when we analyze a stock, we gather information on various stakeholders, including competitors. We came across MiX when we first researched **LoJack Corporation (LOJN – $6.45)**, a stock we liquidated earlier this year at a significant premium, thus turning a hefty gain for us! As it happens, MiX enjoys a steady stream of recurring revenues thanks to its superior business model of selling subscription-based services. The stock used to trade at a higher multiple than LoJack but, when the LoJack deal went through, MiX's share price incidentally came under significant pressure. It dropped from $16 at the time of the IPO in 2013 to less than $4 earlier this year as MiX faced a perfect storm caused by two main factors. First, as a significant portion of their revenues and profits are generated in South Africa, the rand's 25% devaluation last year reduced the company's profits in USD terms significantly. Second, clients in the oil and gas services industry—MiX's largest vertical market outside South Africa—reduced their fleet size, putting a squeeze on the company's growth.

That said, they still managed a double-digit increase in subscribers last year and raised their average monthly revenue per client. As these headwinds abate, we are optimistic MiX can leverage their global footprint to grow profits and bring their margins more in line with those of their peers. Moreover, regulatory changes in the United States could play to the company's advantage. Finally, their strong balance sheet, with a net $1.90 in cash per share (50% of the company's then value) was a great asset that they put to work earlier this year when they bought back 25% of the company's shares from its largest shareholder at a discount to the then stock price (the repurchase was done at $3.94 per share) ! We expect further growth in terms of subscribers, revenues, margins and profits. With the stock still trading at a discounted valuation to peers, we can expect significant gains from this investment.

Risk management

In an environment where asset prices have shot up substantially and many people fear the stock market is due for a correction, risk management is an issue of topical interest. To quote legendary value investor Benjamin Graham: *"The essence of investment management is the management of RISKS, not the management of RETURNS."* For us, risk management rests on two fundamental pillars. First: a deep knowledge of our stocks. By having a concentrated portfolio and a low turnover, we spend a great deal of time analyzing new and existing investments. By doing so, we can identify company-specific risks and stress-test our profitability models. Second: discipline. Once our research is completed, we determine an intrinsic fair value. Because of the flexibility that our investment policy allows, we can wait for shares to be trading at a significant discount to this intrinsic value before buying, thereby limiting our downside risk. Then, when an investment reaches its full value, we can sell, lock in our profits, and wait for the next opportunity to come along.

This is precisely what happened in Q3. As detailed in our Q2 letter, in the midst of the Brexit tumult, we focused on two of our holdings that had exposure to the U.K. economy. First, where the **Penske Automotive Group (PAG – $48.18)** is concerned, the Brexit vote ended up creating a great buying opportunity, which we seized by scooping up more shares in the low $30s. Despite the uncertainty, Brits continued to buy new cars this summer and, in line with our assessment of the U.S. market, car maintenance continues to be a steady profit centre for UK dealerships. Company CEO Roger Penske spotted the bargain as well and personally purchased 2.6 million shares for more than $100 million during the quarter. This stock was our best performer in the period, as it shot up 59%. As the stock's sharp appreciation increased its weight in the portfolio substantially, we trimmed the position. Second, **Jacobs Engineering Group (JEC – $51.72)**, too, rebounded in Q3. When we bought the shares, our target price was in the mid-$50s, at an implied multiple of 17x our projected earnings for the company. Expecting the pound's devaluation to have a negative effect on the company's profitability, we shaved a couple of dollars off our intrinsic value and, when the stock hit $54, we sold.

We are not always right

We also liquidated **Hornbeck Offshore Services (HOS - $5.50)**, an unprofitable investment for us. We must emphasize that our decision to sell was not triggered by a self-imposed stop loss. Nor was it made because we lowered our earnings estimates owing to the very difficult industry conditions prevailing at the moment, as this was already reflected in the share price. We sold because we were wrong on a core element of our investment thesis, namely, our expectation that high-end multi-purpose support vessels would continue to experience stable utilization and pricing. We invested in Hornbeck thinking that these vessels could provide some earnings stability. As it turned out, during the past couple of quarters, competition remained stiff and demand softened more than expected, which resulted in lower profitability and higher risk for the business. With the change in the investment thesis, we were no longer comfortable with the downside risk and chose to sell our position.

The proceeds of these transactions remain in cash for the time being. We have been checking our swing of late as none of the potential investments analyzed afforded the margin of safety that we demand. Standing still is not always pleasant, but we are mindful that fixating on a dull market can leave you restlessly craving excitement that quite simply is not there. Consequently, as we continue to look for bargains, you can rest assured that we will exercise the utmost buying discipline before deploying your capital.

Sincerely,

Philippe Hynes

Philippe Hynes, CFA
October 15, 2016

Tonus Composite Performance Report
As of September 30th, 2016

	Tonus Composite Gross Return	Benchmark Return
3 months	7.69%	5.24%
6 months	13.46%	9.46%
YTD	18.87%	8.72%
1 Year	23.72%	13.73%
2 Years	10.06%	9.06%
3 Years	13.56%	14.16%
5 years	19.98%	14.78%
Inception	12.22%	6.59%

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. The firm maintains a complete list and description of composites, which is available upon request. For more information on the investment strategy and complete terms and conditions relating to an investment in the Fund, please consult the Offering Memorandum available on request.