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SECOND QUARTER 2022 - NEWSLETTER

Dear Partner,

Here is our portfolio review and commentary for the second quarter.

Performance Review

During the second quarter of 2022, the TONUS PARTNERS FUND gross return was **-10.1%**. Year-to-date, the Fund achieved a gross return of **-13.5%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound gross rate of return of **8.4%**, compared with **6.8%** for the benchmark[2].

Portfolio Review

This quarter was like no other of late. The markets were steadily overcome by growing pessimism and most stocks, especially darlings amongst retail investors (many acting more as speculators), buckled under the weight of downward pressure. North American markets were down more than 15% in the period. We mentioned previously that the ascending stock prices of unprofitable tech companies were unsustainable. Well, these stocks finally hit a mountain they cannot climb: interest rates. Needless to remind you, because we generally do not invest in unprofitable growth companies in any meaningful way, speculative booms are likely to outpace us. However, all speculative booms, by definition, come to an end. And it is in times of down markets that we shine brightest and prove our value to you, our investors.

Many people are now realizing that investing might not be as easy as it seemed over the past few years, i.e. merely buying stock in the most popular companies will not necessarily make your fortune. Having declined more than 20%, U.S. indices are now firmly in bear market territory. Year-to-date, the tech-heavy NASDAQ is down close to 30% and all sectors but energy are in the red. For the first half of the year, the S&P 500 logged its poorest performance since 1970 and the Russell 2000 small-cap index, which was started in 1984, had its worst showing ever.

In such a context, our approach to focus on quality businesses and valuation served to protect our assets. Though our returns might have been negative, we <u>did not destroy our partners' capital</u>. What's more, we positioned our portfolio to minimize our risk exposure in order to capitalize on the eventual rebound. Our strategy remains the same. We know our investments well, we use our own models to forecast profitability under various economic scenarios, and we maintain our buy discipline to protect our downside.

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

[2] Please see page 5 for a full description of the benchmark along with its historical returns

Inflation fears

Markets have taken a plunge since our last letter as it became clear that inflation was finally top of mind for central banks. Interest rates are moving up, which means a higher cost of capital. Liquidity is waning and the smallest bit of news (negative more often than not) triggers massive swings. With such volatility, the focus is shifting to valuation.

Our simplified explanation of how to value a business always centres on a) long-term profits and b) the market's multiple applied to these profits. On the one hand, capital investment in business should produce a natural increase in earnings per share over time. This growth should, in turn, send a stock's price upward, bearing in mind that economic downturns and cost inflation can put temporary bends in this trajectory. On the other hand, market multiples have averaged 16.5x historically, but they tend to be much more volatile, swinging higher and lower driven by economic growth expectations, interest rates and investor sentiment.

What is behind the market's 25% drop this year? For now, it can be entirely attributed to the market multiple reverting to its mean. It began the year at 21.6x and now stands at 15.9x (-26%). There is no pinpointing when exactly it will bottom out, but given current levels, we are definitely closer to that moment than we were a few months ago. Further short-term pressure is likely but, longer term, these valuations should remain at or above where they currently stand.

This brings us to the second variable: earnings. They will be the key pillar of support for stocks. Profit estimates for 2022 and 2023 are, as a matter of a fact, actually slightly higher from where they stood at the start of this year. This first quarter produced results that beat expectations by 3%, and recent discussions we have had with many executives lead us to believe that the second quarter should be favourable as well. However, recent economic indicators point to a deterioration of demand and an increase in costs in the coming months. The market being a discounting machine, investors are quickly adjusting their valuations for the negative impact of sky-high inflation.

Consequences of high inflation

This elevated level of inflation will hit corporate profitability three ways. First, operating expenses will rise. Since late 2021, raw material and labour costs have spiked. Both are squeezing profit margins. Second, consumers will have less disposable income. High gasoline and food costs are crimping consumer confidence. Spending will taper, corporate revenues will suffer, and earnings will decline. Third, the cost of capital will rise. The time of cheap debt enjoyed by levered companies is over, so borrowing costs will go up and earnings, down.

In such a context, we are focusing on companies that will continue to generate profits and cash as we go through a slowdown/recession. Companies with strong balance sheets will be able to take advantage of this period to buy back their own depressed shares or to make strategic and value-creating acquisitions. Such companies might still see their stock price decline in the short term, but it is our strong conviction that they will maintain and increase their intrinsic value per share over the long term. It is this conviction, supported by our internally developed financial models, that gives us the confidence to buy when others are dumping.

Our portfolio positioning

Our top five investments exhibit the features we are looking for in the current context. During the most recent quarter, we bought more shares of **Comcast Corporation (CMCSA - $39.24)**. Most of their revenues come from internet, cable, and telephone subscriptions - a model that has proven resilient in prior downturns. They will continue to repurchase their shares at lower levels and the stock is currently yielding 2.7%.

Dollarama (DOL – $74.12) should also do well. Historically, they have benefited whenever consumers decide to trade down and stretch their buck. In the great depression of 2009, their same-store sales shot up 7%. We expect their business model to remain strong in the current period.

We also bought additional shares of **Sleep Country Canada (ZZZ - $24.02)** in Q2. While we might expect their sales growth to be hampered by the macro slowdown, we believe that their shares, down 30% year to date, offer a compelling risk-reward ratio at current levels. The stock is trading at 8x our expected 2022 profits, half its historical valuation. Stress testing our models for 2023 under aggressive assumptions, we still expect them to generate $1.75 per share.

What's more, we can be patient with this company and their debt-free balance sheet guarantees that they will continue to provide investors a 3.7% dividend yield. In the long run, we strongly believe that their earnings power will not be impaired; in the short term, they will increase the per-share value of the company by buying back as much of their stock as regulations allow. Finally, we would not be surprised to see private equity funds circle around this company. In 2008, two private equity firms teamed up to buy the company at a 40% premium. We would expect no less this time around.

Next, we own stock in **Vivid Seats (SEAT - $7.47)**, a platform to exchange second-hand sporting and concert tickets. The short-term outlook remains very favourable: people are eager for post-COVID experiences, bands are touring, and sporting events are drawing record crowds. Historically, sporting events have remained relatively immune from economic slowdowns, a characteristic we like right now. Back in 2008-2009, attendance at major-league sports events (NFL, NBA, etc.) sagged less than 2%.

Vivid's business remains highly profitable, they can easily adjust spending as needed, and their balance sheet shows that they hold $50 million in net cash. Moreover, they have been active improving the per-share intrinsic value of the business and they took advantage of their low share price to repurchase their outstanding warrants[3].

Finally, **Napco Security Technologies (NSSC - $20.59)** is a new stock that was added to the portfolio in the quarter. Its strong performance since our timely purchase has already made it one of our top holdings. Napco manufactures alarm control systems and locks. Since 2017, the company has pivoted its model to generate recurring service fee revenues on its connected radios. This caught our attention when we met management in 2018 as it renders the business much less volatile and a lot more predictable. At the previous quarter, we believe they had more than 400,000 connected radios, each generating a high-margin monthly service fee.

[3] Warrants are a derivative that give the right, but not the obligation, to buy or sell a security—most commonly an equity—at a certain price before expiration. They tend to dilute existing shareholders of the company.

They used their strong balance sheet to secure more inventory than their competitors did in the past year, and this enabled them to gain market share. They will also benefit from a required upgrade of many radios this year prior to the phase-out of 3G networks. Their install base could double in the near term, driving revenues higher and generating significantly more EBITDA. Finally, they are introducing a similar model in their locks business. Though still only at a fledgling stage, this has the potential to further boost recurring revenues. Macro factors should have no negative impact on their business.

Keeping the long-term view

The bubble has finally burst for bandwagon investors who must now unlearn a decade of investment learning. We believe that, thanks to our style of business evaluation, we will find even more opportunities in the coming months. We normally focus on earnings and cash flow, and we will do so more than ever at this juncture. Inflation is running red hot at present, but we expect economic forces (normalization of supply chains, cooling off of excess demand) to play out and eventually rein it in[4].

This will lead eventually to a change in the narrative and investors will start looking past the current tightening cycle. Without trying to time this to a tee, we prefer looking at the ratio of upside opportunity to downside risk to select companies that will survive and potentially thrive during the current slowdown, and then establish our upside valuation on earnings power in normal economic conditions. There are plenty of candidates right now with significant upside, but we must be careful to pick stocks with the lowest downside to maximize our risk-adjusted return. We have fared well in the downturn so far, and we will continue to make capital protection a priority while looking for strong returns in the future.

Sincerely,

Philippe Hynes, CFA
July 9, 2022

[4] Case in point, wheat prices had risen sharply in March following the outbreak of the war in Ukraine. It jumped 70% from $8 a bushel to over $13 a bushel. Economic forces played their part and by July 14 the price was back below $8 a bushel.

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

Tonus Composite Performance – As of 06/30/2022

	Tonus Composite (Gross Returns)	*Index*
3 months	-10.1%	-15.5%
6 months	-13.5%	-16.0%
1 year	-17.3%	-11.8%
3 years	7.6%	7.5%
5 years	2.2%	7.1%
10 years	9.0%	10.2%
Since Inception	**8.4%**	**6.8%**

Source: FactSet Research Systems, Inc.
Returns are gross of fees and 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 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.