

Turtle Creek

2007 Letter to Unitholders

Turtle Creek Asset Management is a boutique investment firm applying a private equity approach to identify and surface value in mid and small cap non-resource companies listed on the TSX.

Dear Unitholders,

It was inevitable that, at some point, we would be writing an annual letter to unitholders after a year in which our investment returns were negative. In 2007 our unit price declined 13% in U.S. dollars and 26% in Canadian dollars. As well, our benchmark – the S&P 500 total return index – outperformed the Fund: increasing 5% in U.S. dollars and declining 11% in Canadian dollars. While our long term unit price performance remains substantially above our benchmark, we were disappointed in 2007.

The table below shows the compound annualized returns of the Fund for the past year, five years and since inception (over 9 years ago), in both U.S. and Canadian dollars.

| | U.S.\$ | | C\$ | |
|---------------------------------|--------------|---------|--------------|---------|
| | Turtle Creek | S&P 500 | Turtle Creek | S&P 500 |
| One year return | -13% | 5% | -26% | -11% |
| Five year compound return | 25% | 13% | 14% | 3% |
| Compound return since inception | 38% | 5% | 31% | 0% |

We obviously would have preferred to have posted better results in 2007. In particular, we wish we had done a better job with the relative weightings of our holdings. However, we are less disappointed in the year than would be suggested by the Fund's unit price decline. To help explain our perspective, in this year's letter we will discuss six components of our approach. Finally, at the end of the letter we will explain why it is more meaningful to focus on our U.S. dollar returns rather than our Canadian dollar returns.

1. We care about value not price

We own businesses. In some cases we own less than 1% of the business, in other cases we own 20%, but the same philosophy applies. We come from a private equity background where we owned, in most cases, more than 50% of the companies we invested in. We didn't have a share price to constantly tell us how we were doing. Instead, we had to assess the performance and prospects of our companies. The same applies to Turtle Creek – we pay more attention to the performance of our companies than their share prices. We view the fact that a company is public as simply a bonus, because sometimes we get to buy more of the company at very low prices and sell some of the company at higher prices. These opportunities rarely exist in private equity. We understand that with quoted prices we are measured every month, but we try not to let that affect our investment decisions.

We spend most of our time assessing the value of each company and none of our time guessing what each stock price will do. We believe that the value of an enterprise equals the present value of all of its future cash flows; so, essentially, we spend our time trying to estimate future cash flows. We believe that we are well qualified in this regard. Among the three of us, we have 22 years of investment banking experience at the front end of our careers, where we prepared formal valuations and advised companies



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on acquisitions and divestitures, and, thereafter, 25 years as private equity investors that owned control positions in a dozen different companies. Collectively, we have held 15 positions as directors on the boards of 13 different public and private companies. We have the perspective of business owners rather than speculators.

Our focus is on the 'intrinsic value' of our companies, not their quoted share price. The table below shows the intrinsic value per unit of Turtle Creek at the end of each of the past four years in both Canadian and U.S. dollars. As you can see, the intrinsic value per unit of Turtle Creek actually rose in 2007.

| | 2004 | 2005 | 2006 | 2007 |
|---|---------|---------|---------|---------|
| Estimated intrinsic value per unit (C\$) | \$22.21 | \$26.15 | \$25.27 | \$27.68 |
| Estimated intrinsic value per unit (U.S.\$) | \$18.45 | \$22.43 | \$21.68 | \$28.01 |
| Unit price discount to intrinsic | 48% | 49% | 35% | 56% |

We expect the unit price of Turtle Creek to always be at a discount to the portfolio's intrinsic value. As the price of a holding approaches its intrinsic value, we sell it down and deploy the proceeds into other holdings that are relatively cheaper; and so it is logical that Turtle Creek's unit price will always be at a discount to the portfolio's intrinsic value. In effect, we are trying to maximize the discount to intrinsic. Over a longer period, we have observed the discount ranging from approximately 25% to 50%, with the discount most frequently falling in the 30% to 40% range. The 56% discount at the end of 2007 is the largest we have yet experienced. Simply put, the larger the discount the more comfortable we are with the portfolio. So long as the intrinsic value of our portfolio continues to rise, we know that our unit price will eventually follow and we are always trying to drive the intrinsic value of our portfolio higher.

We have not varied the discount rate used in our valuations since we began the Fund nine years ago and we do not expect to do so in the future. To determine the enterprise value of a company, we typically use a 10% rate to discount its after tax cash flows available for debt and equity holders. In today's low interest rate environment, there are powerful arguments that a company's weighted average cost of capital is lower than 10%. However, we primarily care about the relative value between our investments. More importantly, we do not wish to be whipsawed by changing interest rates such that we are changing our views on valuation every time there is a change in the interest rate environment.

Generally, with no changes to the view of our companies' prospects, one would expect the value of our units to rise by approximately 12% per year – simply the cost of equity component of the weighted average cost of capital. But the world is complicated and, of course, our companies' prospects do change from year to year. In 2007, we reduced our view of intrinsic value on three of our companies, and increased our view on six of our companies. The remaining company intrinsic values were unchanged, other than the abovementioned 12% increase.

2. We focus on current cash earnings

Even after adjusting for the time value of money, we prefer current and near-term earnings to future earnings. We are more confident in our short term cash flow projections than the longer term cash flow assumptions that we make in our valuations. Although we do not use a lower discount rate for near term cash flows, we do take this preference into account when determining our portfolio weightings.

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Because of this bias towards companies that produce strong current cash flows, our portfolio typically has a very high 'look through' yield. The current 'look through' cash earnings of our portfolio (after taxes and maintenance capital expenditures) was about C\$1.75 per unit for 2007 and is approximately C\$2.00 for 2008. We find these to be remarkable numbers and it is worth reiterating: the 2008 'look through' yield of our portfolio based on the December 31, 2007 unit price is approximately 16%. We own companies in our portfolio that we believe will earn substantially more in the future, but even the current cash earnings level is very strong.

We don't want to leave the impression that we only own companies that generate significant current cash flow. About 20% of the portfolio is invested in high growth companies that currently produce negative, little, or no cash flow but that we believe will make substantial profits in the future. It would be wrong to try to categorize us as either 'value' or 'growth' investors. We don't believe the distinction is meaningful. We invest both in companies that have moderate growth prospects but that are trading at very low multiples as well as companies that have very high growth prospects but high or infinite current earnings multiples. The distinction between value and growth becomes meaningless when you subject every company to a detailed financial model that captures expected future results. Having said all of this, as we mentioned above, we have a bias toward companies with valuations predicated more heavily on current cash flows, simply because we are more confident in our near-term cash flow forecasts.

3. The Fund has low financial leverage

In the current environment of exceedingly skittish credit markets, with concerns about overall corporate debt levels and new financial instruments such as asset backed commercial paper, collateralized debt obligations, credit default swaps, and all manner of derivative financial instruments, we want to reiterate that we follow a very boring investment strategy: we own common shares of companies. We don't employ options, futures or other derivatives to boost our returns and increase risk. We understand and manage financial leverage to target an unlevered portfolio of reasonably and prudently capitalized investments. We have a policy and practice of holding cash at the Fund against companies that have debt that is in excess of reasonable and prudent senior debt levels; and holding debt at the Fund against companies that have debt that is below reasonable and prudent senior debt levels. In 2007 total 'look through' debt to EBITDA for our portfolio was less than two times.

4. We are a fully invested fund

We do not try to time the market. Nor do we take a stance on whether or not the stock market is overvalued or undervalued. Instead, we take a stance on whether or not each of our companies is overvalued or undervalued. There have been a few periods of high valuation where we were not fully invested simply because the price of some of our companies rose to such a level that we were no longer interested in owning very much. For example, during the buoyant markets of 1999 and early 2000 we had net cash of as much as 26%. But this was an anomaly: it is an unusual situation where we cannot find a quality company to own that offers a superior risk return proposition relative to investing in treasury bills. To be sure, if we could time the market and knew for certain that stock prices were going to fall, then we would simply sell everything, wait for the decline and then reinvest all of our money. We do not believe, however, that it is possible to consistently forecast the direction of the stock market in the short term. Therefore, as long as we can find companies that are generating strong cash flows, have excellent growth prospects and are trading below intrinsic value, we are likely to be a fully invested fund. We believe that the best way to earn superior investment returns over the long run is to stay invested.

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A consequence of being a fully invested fund is that in weak stock markets we are likely to see a decline in the price of our units. Companies that we purchased at attractive valuations become even more compelling investments after a market downdraft. Over the longer term, so long as their quoted prices move towards their intrinsic value, Turtle Creek's unit price performance will be strong. We are not troubled by poor short term unit price performance as long as we believe that we are making the right investment decisions to drive the portfolio's intrinsic value higher.

5. We look for companies that will have large share price changes

Rather than avoiding a company with a volatile share price, we embrace such a company because its share price movements afford us with the opportunity to add to the position at low levels and reduce the position at higher levels. Our approach is the opposite of the great majority of market participants who increasingly focus on reducing price volatility. Our letter last year was all about risk and does a pretty good job of describing our views in this regard. We encourage you to reread that letter. Doing so will help illustrate why we are not flustered by price movements.

In terms of the criteria for our ideal investment, we like companies that have low intrinsic value volatility and high share price volatility. Specifically, we look for businesses that are hard for the market to understand, particularly ones that have few comparable public companies in the Canadian market. We try to invest in businesses that are either already great or ones that have management teams with the vision, drive and capability to create a great company.

6. We understand the importance of context

While we continue to look for new investment opportunities (we added five new investments in 2007 and removed four), the bulk of our portfolio holdings are the same as they were at the beginning of the year, as is the case each and every year. At Turtle Creek we understand the importance of context. It takes time to really understand a company, its management team and industry. To the extent that we have that understanding and context, we become more confident in our view of intrinsic value and more confident that we will know how to correctly adjust this view based upon new information. Often there are companies that we look at that appear to be cheaper at a point in time, but we recognize that context is required before we can confidently say that these companies truly represent better risk return opportunities and so we begin cautiously with each new good investment opportunity. We recognize that 'the grass is not always greener'; however, we are constantly looking to upgrade the quality of the list of companies that we follow. We will upgrade when we find a company that, in terms of quality, price and a variety of other factors, surpasses the least attractive of our existing holdings; but we do this carefully and gradually.

Turtle Creek is not a fund that tries 'new things' if our unit price lags. Again, we believe that the value of any investment is the cash flow that it generates. That is not an investment approach that goes 'out of style'. There are many investment strategies that work for a time and then fall out of favour. We follow the cash. In 2007 we have not, for example, 'lost' money on a set of investments, sold them and then reinvested in a new set that we hope will do better. We own the same companies, by and large, are comfortable that they are performing well, and are confident that they will continue to prove to be good investments.

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We focus more on our returns as measured in U.S. dollars

You will note that we present our historical performance in both U.S. and Canadian dollars. As we explain below, because of the nature of the companies that the Fund owns, we believe that our performance measured in U.S. dollars is more relevant.

When we started Turtle Creek over nine years ago we chose the S&P 500 as our benchmark and, as you know, we have always compared ourselves against the U.S. market, not the Canadian. We do not own any resource stocks and we are focused on companies that are at least North American, if not global, in their scale of operations. In other words, we primarily own "U.S." companies that happen to be headquartered in Canada. Indeed, many of our companies use the U.S. dollar as their functional currency. In comparing our performance against our benchmark, we have always converted the S&P 500 into Canadian dollars. We could just as easily convert Turtle Creek into U.S. dollars for comparative purposes, and indeed, this better reflects the underlying economics. Accordingly, it is more appropriate to consider Turtle Creek's unit price in U.S. dollars, although we have quoted, and will continue to quote our unit price in Canadian dollars since the vast majority of our unitholders are Canadian.

In the long run, the choice of which of the two currencies is used to measure our returns is not that relevant since the Canadian and U.S. economies are closely tied and the long term net change between the two currencies will be negligible versus our long term investment performance. Canada and the United States are deeply integrated economies with similar inflation rates. During the 25 year period prior to 2003, the U.S. dollar exchange rate did not fluctuate by more than 21% in any five year period. In contrast, during the past five years, the Canadian dollar has appreciated by more than 57% relative to the U.S. dollar. This recent rapid appreciation has meaningfully impacted our performance when quoted in Canadian dollars.

Our approach to currency is simple: we do not try to make short term (two to three years) predictions as to where the exchange rate is going. There is strong empirical evidence that exchange rate predictions in this time frame are completely unreliable. We believe that the long term equilibrium value between the Canadian and U.S. currency is purchasing power parity which, according to the OECD and other authorities, is approximately 83 cents. So, in the early years of the Fund, when the Canadian dollar was around 70 cents, we biased toward Canadian cash flows. Today, with the dollars at parity, we are biased toward U.S. dollar cash flows since we believe that the U.S. dollar is undervalued relative to the Canadian dollar.

To be clear, we do not own and have not owned companies that have made their living by selling product made in Canada to the United States based on a cheap Canadian dollar. Our portfolio is roughly directly hedged to the U.S. dollar, because most of our companies are essentially 'American', with the remainder of our companies either modestly benefiting from or modestly harmed by an overvalued Canadian dollar.

Conclusion

When you put all the pieces together, our approach can be summarized as follows. Get the intrinsic value right and the share price will follow; bias the holdings toward current cash generation; ensure that the portfolio has no more than a prudent senior debt level of financial leverage; stay fully invested; embrace price movements as an opportunity to add to holdings that decline and to reduce holdings that rise; and,

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finally, have a stable portfolio so that we are not 'whipsawed' but, at the same time, continually look for better investment opportunities to upgrade the group of companies that we follow.

We understand that as a unitholder you are on the outside looking in and have no way of assessing the portfolio, other than your knowledge of us and the track record of the past nine years. All we can tell you is that, as our private equity investments are sold, we continue to place all of our liquid assets into Turtle Creek and we look forward to the point in time when all of our money is in the Fund. For the first time in many years the three of us are back under one roof. The timing of this reunion has, ironically, coincided with a decline in our unit price. But that is a coincidence. We are excited about being together every day, meeting new companies, talking over our investment decisions, and constantly striving to generate superior investment returns.

Your Partners at Turtle Creek.