Turtle Creek

Q1 2020

Quarterly Manager Commentary

The net asset value of the Turtle Creek Equity Fund[1] ("TCEF") decreased 35.0%[2] in the first quarter of 2020. This was greater than a decrease of 20.9% for the S&P/TSX Composite index and a decrease in the S&P MidCap 400[3] index of 23.2% (in Canadian dollars). During the quarter, we removed two companies to end March with 25 holdings – 13 Canadian companies comprising roughly 44% of the portfolio and 12 American companies comprising 56%.

Turtle Creek United States Equity Fund ("TCUS") declined 36.5%[2] in U.S. dollars during the quarter, compared with a 29.7% decrease in the S&P MidCap 400 index in U.S. dollars. During the quarter, we added one company and removed three to end with 23 holdings.

Turtle Creek Canadian Equity Fund ("TCCF") declined 37.8%[2] during the quarter, compared to a decrease of 20.9% for the S&P/TSX Composite index. During the quarter, we added two companies and removed one to end with 26 holdings.

As the COVID-19 pandemic engulfed the world, financial markets were thrown into turmoil. And so, this quarter was one for the record books, at least since Turtle Creek began. The market decline was its largest in the past 21 years and so it was for Turtle Creek. As to why our decline was larger than the market, we don't have any particular insights. We often tell you that we don't try to read the mind of the market, and this time is no different. Despite what we believe to be a high-quality portfolio of great businesses, across a diverse set of industries with strong fundamentals, we are not overly surprised at our short term price performance as this has occurred in prior periods of market dislocation. But more on this later.

In this commentary, we will focus on the likely impact that the pandemic and resulting recession will have on our portfolios, including providing commentary and context on our larger holdings. We are neither economists nor epidemiologists, but one thing we do know is the pandemic and resulting recession will not last forever. This recession is unlike traditional recessions, which are driven by a decline in demand, as the trigger here is akin to a natural disaster or 9/11 scale terrorist attack, that induces a sharp "pause" in economic activity.

The most important consideration in this environment is whether our companies have the balance sheet strength to weather the storm of what is clearly going to be a sharp and severe recession. As we have shared with you in the past, we are attracted to companies that generate lots of cashflow and therefore don't require access to the capital markets to grow their businesses. We often say that if the stock markets were to close, our companies would continue on as before, generating cash to invest and grow their businesses. We try very hard to identify the management teams that are 'highly intelligent', focused on making those decisions necessary to react to whatever the economy throws at them. As such, our management teams tend to run their businesses with fairly conservative balance sheets. In fact, many of our companies had already been prudently adjusting their leverage downward in contemplation of a cyclical downturn, albeit not in anticipation of a pandemic. In the last few weeks, we have had conversations with almost all of our companies as to what they were seeing and how they were reacting. Based on these discussions and the internal work we have done, we do not expect liquidity issues with our companies that will have a meaningful impact on our portfolio. Counterintuitively, a deeper recession could set some of our companies up for a stronger rebound as, in many cases, we believe they are the leader in their industry.

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The best way to think about the portfolio in the current environment is to place our companies into three categories. In Category One are companies that may be minimally impacted by the pandemic recession, and where, in a few instances, intrinsic value (our use of the term 'intrinsic value' is interchangeable with Cash Flow Value)[4] could well increase as a result of the recession. In Category Two are companies that are impacted by the pandemic recession but where the recession may actually strengthen their longer term competitive position thereby offsetting the short term loss of earnings so that there is minimal change to intrinsic value, in either direction. In Category Three are those companies that may be impacted by the pandemic recession such that there is genuine 'demand destruction' which is not recovered down the road, causing a reduction in intrinsic value.

TCEF's portfolio is roughly structured as follows: 40% into Category One; 20% into Category Two; and, 40% into Category Three. For TCUS and TCCF the breakdown is roughly the same. We discuss the three categories below and profile a few significant holdings in each category so that you can see how we are thinking about our holdings[5].

Category One: **40% of portfolio** *Minimal impact from the pandemic recession, and where, in a couple of instances, value could potentially increase.* This category includes, among others, our two largest holdings in TCEF.

Our largest holding is the largest plastics company in the world, producing a broad range of consumer packaging and engineered materials as well as health and hygiene products. It does not participate in some of the more criticized aspects of the plastics industry, including plastic bags and water bottles. As the plastics industry leader, the pandemic creates an opportunity to educate the public (and investors) on all the good uses for the substrate. Of note in the current environment, they manufacture the material used in the production of disinfecting wipes, medical garments and surgical masks. Currently, the surge in demand for health and hygiene products as well as for basic consumer staples are offsetting the softness in markets like industrial and cosmetic. Importantly, their margins and cash flows should benefit in the short term from lower resin prices. They operate 300 plants around the world with only two plants currently facing modest disruptions as of last week (both in northern Italy). As a highly acquisitive company, the downturn may present compelling opportunities to make acquisitions of weaker competitors, particularly in segments experiencing weaker demand. Overall, we see them coming out of this crisis in a stronger position.

Our second largest holding is a North American specialty food company that has grown both organically and through accretive acquisitions over the last 20 years. One of their divisions, which is smaller with lower margins, services restaurants in Canada and, of course, it has been negatively impacted by the pandemic. But where demand has fallen off in the foodservice sector, demand in the retail channel has jumped. In fact, they have curtailed their usual promotional activity because they simply can't satisfy the increased demand. And importantly, their retail business generates higher margins than their foodservice division. Their sandwich business may also be negatively impacted, as it is also exposed to the restaurant sector, but they are anticipating to at least partially offset these lost sales with a number of new initiatives for retail. We also expect that the downturn will ultimately allow them to create more value through their acquisition program than we had previously assumed.

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Another example in this category is our fourth largest holding, the largest fund administrator in the world. Fund administration and related services, along with a now meaningful business in administering prescription and health benefits represents 50% of their revenue with software and services making up the other 50%. All areas of their business exhibit high recurring revenue with very little being linked to the AUM of their clients – we believe it is a very resilient business in an economic downturn. They are very acquisitive and, in this environment, could end up buying companies at attractive prices.

One company in this category that could see a meaningful uptick in its intrinsic value is one of the largest purchasers of portfolios of charged-off debt from financial institutions. The company acquires the charged-off debt for pennies on the dollar and then works with individual debtors over a multi-year period with the objective of collecting sufficient cash to generate a positive return on their investment. Of the companies in Category One, their short-term results may be the most impacted by a downturn in collections (as individuals are unable to maintain their small repayment plans). However, as the best capitalized company in their industry, we expect that this will be more than offset by their opportunities to purchase new portfolios at attractive prices. They had already positioned themselves with a strong balance sheet in anticipation of a recession (although they didn't see a pandemic coming) so they could significantly ramp up portfolio purchases, both in North America and Europe. In the Credit Crisis, they were able to create significant value for shareholders by purchasing portfolios when their over levered competitors had to pass and we expect the same could occur, particularly in Europe, as a result of this downturn.

Category Two: **20% of portfolio** *Impacted by recession in the short term but minimal change to intrinsic value in either direction because companies should emerge stronger which should offset lost earnings.* Included in this group are three of our top ten holdings in TCEF. These are companies that will be more impacted than Category One companies by the recession but where we believe there are longer term offsets which will leave intrinsic value unimpaired.

One of these is the dominant hydrovac excavation company in North America. While some of their services have been designated as an essential service and should result in lots of work through the recession, we are assuming a decline in overall revenue and profits in the short term. But the offset is that, in this environment, we believe their superior technology and corporate size will outshine smaller competitors and we anticipate they will take market share as a result. Of note, they provided a business update the other day and reiterated their goal of doubling their U.S. business over the next three to five years.

A couple of our other top ten holdings have similar profiles although in different industries: the first is one of the largest trucking companies in North America and the second is a global provider of industrial equipment, technologies and related parts and services to a broad and diverse customer base (air compressors, pumps, etc.) It operates primarily in the industrial and medical segments. They have plants around the world, are quite diversified and, in fact, produce some components that are required for ventilators. With both companies, we think smaller competitors will fall away in this environment (especially for our trucking company) and that both companies may have the opportunity to make accretive acquisitions at attractive prices.

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Category Three: **40% of portfolio** *Impacted by recession resulting in a reduction in intrinsic value.* Included in this group are several of our top ten holdings and we highlight the three largest here. These are companies that will be impacted by the pandemic recession and, accordingly, we have reduced our intrinsic value estimate.

Our largest holding in this category is one of the largest global automotive parts and systems suppliers, particularly for propulsion systems for internal combustion, hybrid and electric vehicles . All of the American, European and Asian OEMs are customers. As a result of the pandemic recession, we are forecasting a sharp curtailment in automotive production for 2020, followed by a gradual recovery to more normal levels through 2021 and 2022. This results in roughly a 10% reduction in our estimate of the company's intrinsic value. We believe they have a strong balance sheet and are well positioned to weather the recession. Tellingly, unlike a large number of companies in the automotive industry, it has *not* drawn down its banking revolver. They have ample liquidity and had already been adjusting their capital structure to be more conservative.

The next largest holding is a manufacturer of commercial cooking equipment, industrial food processing equipment, and residential kitchen appliances. Their commercial cooking equipment segment does business with 97 out of the top 100 foodservice chains in the United States and internationally. The current situation with in-dining restaurant activity will clearly have an impact on the company's sales in the nearer term. While there will be a big short term impact on their results, they are over indexed to the chains which have more take-out and delivery than the independents. At the end of the day, they provide the equipment that produces food, whether it is in restaurant, for home delivery or prepared in the home. We believe they have a strong balance sheet and are well positioned to weather the recession. The company is acquisitive, and this environment may provide attractive acquisition opportunities. We estimate that the pandemic recession will reduce the company's intrinsic value by roughly 5%.

The third largest holding in this category is a fashion retailer with three distinct banners. They have always maintained a low physical store count around which they have wrapped an excellent omni-channel strategy. Before the pandemic, the company's online purchases accounted for close to 50% of its sales, a high percentage compared with other apparel retailers. They have a strong balance sheet with net cash of $500 million. Currently, all of their physical stores are closed and it is unclear at what point they will reopen. We estimate that the pandemic recession results in a 15% reduction in the company's intrinsic value. Despite the challenges, like the rest of our companies we are confident that management is making highly intelligent decisions to respond to the challenges.

As we have said many times, we believe we have invested in a portfolio of great businesses, across a diverse set of industries with strong fundamentals. Now that we have spoken with almost all of our companies, we have begun the process of assessing in detail the impact of the pandemic recession on the intrinsic value of each company, prioritizing those in Category Three. Based on our work to date, we estimate that a pandemic recession has the effect of modestly reducing the intrinsic value of our portfolios. When we complete this analysis, we would not be surprised if most, and maybe all, of the decreases in intrinsic value are offset by the rebalancing (our Continuous Portfolio Optimization) that we did in the quarter.

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We take great comfort in the quality of the companies we have chosen to invest in and so are not worried by periods of underperformance, such as this quarter. As we mentioned in the beginning of our commentary, we have witnessed this a number of times before, during prior periods of market dislocation. For example, in Q1 2008, in the early days of the Credit Crisis, TCEF's unit price was down 16% versus the TSX down 2%. And in August of 2011, during the Greek debt crisis, TCEF was down 18% vs the S&P 500 down 6%. If you think about it, we don't own 'household names' or what is traditionally thought of as 'blue chip' stocks. We own an idiosyncratic portfolio of mid-market capitalization companies that we believe are world class and will navigate through this environment, but that doesn't mean their share prices won't decline more than the average in the short term. As we have described in the past, we look for great companies but are particularly drawn to those that might be more difficult for the market to understand. So, perhaps it makes sense that at a time of unusual market dislocation our holdings drop more than the overall market.

The recession triggered by the pandemic could turn out to be less severe than what we are modeling or perhaps more so. But the sad fact remains that it didn't have to be this bad. In our opinion, Canada's response has been ok – not perfect, but our government took the threat seriously and we think we will be on the mend soon enough. On the other hand, the response by the United States has been woefully inadequate. The threat was politicized, diminished and testing was badly delayed. As such, the virus has run rampant. And this in one of the richest, most technologically advanced countries in the world. But the Americans are a resilient bunch and they will rally to the cause. They will experience deaths that were preventable, but they will prevail. Already, you are seeing significant 'flattening' of the rate of infection in Europe. At some point in the not too distant future, some semblance of normalcy will return to our everyday lives.

We hope that you and your loved ones are safe. Here at Turtle Creek, all of our employees and their families are healthy. We have been focusing on heeding the experts' advice in order to protect those most vulnerable in our community. For several weeks now, we have been working remotely and the change has gone smoothly as we had previously invested in technology and business continuity procedures to allow for a seamless transition. As investment managers, we are fortunate to be able to continue what we do without much disruption. But what we do does not put our health or lives on the line. For those of our investors who are on the front lines, we owe you a debt of gratitude. Thank you.

Disclosures

Information sources: Turtle Creek Asset Management Inc., Bloomberg.

Past performance must never be construed as investment advice or a prediction of future performance. We have expressed our own views and opinions in this document and these may change without notice and may differ from others in the industry. This commentary contains forward-looking statements. All statements, other than statements of historical fact, that address activities, events or developments that we believe, expect or anticipate will or may occur in the future (including, without limitation, statements regarding any objectives and strategies of the Fund or outlooks for the portfolio companies) are forward-looking statements. These forward-looking statements reflect our current expectations, assumptions or beliefs based on information currently available. Forward-looking statements are subject to a number of risks and uncertainties that may cause the actual results of TCEF, TCCF or TCUS (the “Funds”) to differ materially from those described in the forward-looking statements, and even if such actual results are realized or substantially realized, there can be no assurance that they will have the expected consequences to, or effects on, a Fund. Factors that could cause actual results or events to differ materially from current expectations include, among other things, length and severity of the pandemic, volatility in financial markets, fluctuations in currency exchange rates and interest rates, tax consequences, changes in applicable laws and other risks associated with investing in securities and those factors discussed under the section in the applicable offering memorandum of a Fund entitled “Risks and Special Considerations. Any forward-looking statement speaks only as of the date as of which it is made and, except as may be required by applicable securities laws, we disclaims any intent or obligation to update any forward-looking statement, whether as a result of new information, future events or results or otherwise. Although we believe that the assumptions inherent in the forward-looking statements are reasonable, forward-looking statements are not guarantees of future performance and, accordingly, undue reliance should not be put on such statements due to the inherent uncertainty therein.

Comparisons to certain indices are provided for illustrative purposes only, and are intended to indicate broad market performance. Comparisons to indices are limited because indices are not managed and do not charge fees or expenses. Our Funds may underperform or outperform the indices for many reasons.

Endnotes

1. Turtle Creek Investment Fund maintains a portfolio that is almost identical to Turtle Creek Equity Fund.
2. Based on the change in net asset value of the fund’s Class I, Series 1.0 Units.
3. The S&P/TSX Composite index is a Canadian index and represents approximately 70% of the total market capitalization on the Toronto Stock Exchange. The S&P/TSX Composite index is a total return index. The S&P MidCap 400 index is a stock market index from S&P Dow Jones Indices which aims to serve as an indicator of U.S. mid-cap equities. It covers nearly 7% of the total US stock market. The S&P MidCap 400 index is a total return index. Returns for both indices are shown in Canadian dollars unless indicated otherwise.
4. A company’s Cash Flow Value represents our best estimate of the present value of such company’s future cash flows on a per share basis and is necessarily comprised of many assumptions, the use of which includes a number of risks and uncertainties that may cause actual values to differ from our estimate. A fund’s Cash Flow Value is calculated using our estimate of Cash Flow Value for each company, weighted based on the relevant fund’s holdings at each calendar year end.
5. The U.S. names and Canadian names discussed are owned in TCUS and TCCF respectively.

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