Turtle Creek

Q2 2020

Quarterly Manager Commentary

At the time of our last quarterly commentary, the market was still very much in the throes of a crash. Since then, while the market, as well as the traded prices of our portfolios, have recovered a majority of their declines, we remain in the midst of a pandemic and a resulting recession of unknown length and severity. While share prices will undoubtedly move around, we spend our time trying to understand the impact of the current environment on the cashflows (both near term and longer term) of our portfolio companies. In the first part of this commentary, we will provide you with our thoughts on how the pandemic has affected our portfolio, along with an updated picture of the pandemic's impact on our three largest holdings. The second part of the commentary turns to the collective earnings power of our portfolios which illustrates the attractive valuation of each of our funds. At the end of the commentary, we present the short term results of our portfolios, along with that of the market.

Across the portfolios, company results for the first quarter and their comments and monthly data on how the second quarter is tracking, have been better than our expectations. The lockdowns that have occurred to varying degrees around the world have absolutely had a negative impact on the revenue and profits of many of our holdings. But, to date, the impact has not been as great as we had been modeling. As the pandemic continues and, in particular, as the United States struggles to control case growth, we shall see if this continues to be so. In the next few paragraphs, we provide commentary on our three largest holdings. Not only is this an update on our large holdings, it also provides a sense of the overall portfolio.

Our largest holding in both Turtle Creek Equity Fund[1] ("TCEF") and Turtle Creek United States Equity Fund ("TCUS") is the biggest 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. They are one of only a few companies that did not withdraw their 2020 guidance (which was provided in late 2019) at the onset of the pandemic. Their Q1 results were ahead of expectations and, in recent discussions, they are now describing their guidance for the rest of the year as 'conservative'. We would not be surprised if results exceed their guidance. Despite its operational strengths, it was not immune from the market declines and so we were able to buy additional shares at very attractive prices. The share price has since fully recovered from its decline and we have now sold, at higher prices, all the incremental shares we purchased during the crash.

Our second largest holding in TCEF and largest in Turtle Creek Canadian Equity Fund ("TCCF") is a North American specialty food company that has grown both organically and through accretive acquisitions over the last 20 years. As with all of our companies, we've had numerous conversations with this management team in the past few months. In our most recent update call, they highlighted how great their year started off – weekly sales for January through March were well ahead of last year (Q1's organic growth came in at 14%) as the new programs they had been working on last year began to produce results. That all changed in April as lockdowns were enacted throughout North America. Some channels saw spikes (retail and club store) while others (quick service restaurants and white

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table cloth) dried up completely. However, the drought was quite short lived – the pandemic, in hindsight, only impacted them for one month. By May, revenues had bounced – their QSR business had sharply rebounded and fine dining was starting to pick up in Western Canada. In fact, as of early June their weekly sales were back to their pre-pandemic level of performance. While we had assumed that Q2 2020 revenues were going to be down approximately $100 million compared with last year, we now believe they will be flat, if not slightly ahead of last year – a remarkable turnaround from the depths of April. Of note, they recently raised $300 million of equity (through issuing $150 million of convertible debentures and $150 million of common shares). As they had a very strong balance sheet before the equity raise, we believe this is indicative of a remarkably large and robust acquisition pipeline. The company's strategy is to acquire high quality food businesses run by strong entrepreneurs and we suspect the recent environment has convinced some of those entrepreneurs to join a like-minded, highly respected larger organization. We believe they have done all the right things during the pandemic and will emerge an even stronger company.

The third largest holding in TCEF and second largest in TCUS is a manufacturer of commercial cooking equipment, industrial food processing equipment, and residential kitchen appliances. While the current situation with dine-in restaurant activity is clearly impacting the company's sales in the near term, they are over indexed to quick service restaurants which have more take-out and delivery than other formats. Most of their chain customers are financially strong, and many have commented that they believe pandemic related disruptions will result in an opportunity to accelerate their own growth over the medium term at the expense of the independents. In addition, this company is working with several large players in the food delivery space to develop highly automated, high-throughput 'ghost kitchens', that combine equipment from their commercial cooking equipment and their food processing segments. At the end of the day, they provide the equipment that produces and prepares food, whether it is served in restaurants, for home delivery or prepared in the home. It is worth noting that prior to the market crash, this company was not our third largest holding in TCEF (although it was a top ten holding). The substantial share price decline in March provided us with the opportunity to purchase significantly more shares at very attractive prices. With the price having partially recovered, it is now our third largest holding.

We believe each of these three companies will come out of the recession stronger. This is partly because weak competitors will struggle in this environment and partly because all three companies will have the opportunity to make especially accretive acquisitions. Also, we believe each company is making the right strategic decisions to be strongly positioned when we return to a more normal economy. Indeed, we believe this applies to the overwhelming majority of our portfolio: our companies will come out of this pandemic-induced recession in a stronger position.

In our Q1 commentary we wrote: *"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, if not all, of the decreases in intrinsic value are offset by the rebalancing (our Continuous Portfolio Optimization) that we did in the first quarter."* In fact, that is what happened. As of the end of June, the intrinsic value of TCEF is 4% higher than at the first of the year. Every year in our annual letter, we include a section that describes the change in intrinsic value (which we call Cash Flow Value[2]) for the previous five years. We think investors should pay attention to this since it is a better short term metric to evaluate how the fund is really doing than the change in the unit price. We have now added this measurement to our monthly fact sheets so investors can receive a more frequent update on how the intrinsic value is tracking.

The second part of our commentary turns to the cash earnings of our portfolios. We define cash earnings as the earnings that are available to shareholders after all costs to run the business. Sometimes cash earnings are the same as accounting net income, but in many cases for the companies we own, there are non-cash accounting expenses that should not be expensed as they are not reflective of true economics. A great example is the amortization of intangibles that arise from acquisitions.

On a look-through basis, the 2019 cash earnings of TCEF was about $5.50 per unit.[3] With a unit price of roughly $51 at the end of June, this represents a trailing price earnings multiple ("P/E") of a little over 9 times. For 2020, we were estimating cash earnings per unit of about $7, which represents a P/E multiple of 7.5 times, much lower than the overall market.

Of course, because of the pandemic recession, many of our companies will have lower earnings than our original estimates, with some being significantly lower for this year. Nevertheless, we believe this impact is temporary. Indeed, we think most of our companies whose earnings are supressed in this period, will emerge stronger as a result of the recession. So, we believe the cash earnings of $7 per unit is a reasonable estimate of the *normalized* earnings power of TCEF.

Not only is TCEF trading at about 7.5 times normalized earnings, we believe there is a lot of growth in the earnings. Based on our forecasts, the cash earnings more than double over the next five years, equating to an annualized growth rate of over 15%. Our two country funds, TCUS and TCCF, are similarly attractive from a valuation perspective.

Our portfolios are trading at significantly lower multiples than the broad market and, at the same time, they are expected to have higher growth rates. In addition, the portfolios are comprised of companies that we believe are leaders in their respective industries. In terms of what this might mean for future returns in the near term, we cannot say for sure, but owning a portfolio of leading companies trading at single digit multiples of normalized earnings with a high earnings growth rate is a very good place to be, regardless of what we next face.

During the quarter, the net asset value of the Turtle Creek Equity Fund increased 27.3%.[4] This was greater than increases of 17.0% for the S&P/TSX Composite index and 19.2% for the S&P MidCap 400 index (in Canadian dollars).[5] We made no additions or removals to the portfolio to end June with 25 holdings – 13 Canadian companies comprising roughly 45% of the portfolio and 12 American companies comprising 55%.

Turtle Creek United States Equity Fund increased 30.7% during the quarter, compared with a 24.1% increase in the S&P MidCap 400 index (both in U.S. dollars).[4] We made no additions or removals to the portfolio to end the quarter with 23 holdings.

Turtle Creek Canadian Equity Fund increased 34.5% during the quarter, compared to an increase of 17.0% for the S&P/TSX Composite index.[4] We made no additions or removals to the portfolio to end the quarter with 26 holdings.

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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. A company's intrinsic value or 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.
3. Cash earnings and the price to earnings ratios are shown for Turtle Creek Equity Fund Class I Series 1.0 Units. Cash earnings estimates for TCEF are based on each company's operating cash flows before changes in working capital less maintenance capital expenditures.
4. Based on the change in net asset value of the fund's Class I Series 1.0 Units.
5. 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.

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