Turtle Creek

Q3 2020

Quarterly Manager Commentary

Long time readers of our quarterly commentaries will know that, in addition to portfolio updates, we typically allocate a lot of space to writing about our investment philosophies. But not this year. As the world remains squarely in the grip of the pandemic, we will continue to do what we have done in our recent commentaries: focus on our company results and changes we have made in the portfolios. We will return to our philosophical musings when the world is back to a more normal state. So, in this, our third quarterly commentary of the pandemic, we provide a retrospective on what we have done since February, an update on how our companies performed in the second quarter (impressively) and finish with some observations on how we think our investment approach has served us well this year.

When the pandemic hit Europe in February and North America in March, our first focus was to confirm that all of our companies had the proper liquidity to manage through the extraordinary circumstance of lock-downs. We have always been attracted to companies that generate positive cashflows and don't require access to the equity capital markets in order to fund their operations. We also seek out companies that are run by management teams that recognize the importance of capital allocation – and that having appropriate levels of debt within their capital structure is good for their shareholders. But a pandemic changes everything. And so in such a unique time, we were especially focused on the timing of any upcoming payments that could impair their ability to take full advantage of opportunities. Company by company, we confirmed that they had the liquidity to manage through an even more severe and prolonged lock-down than actually occurred.

The second focus was to assess whether the outlook for any of our companies had been permanently altered as a result of the pandemic. In short, we do not think any of our holdings have had longer term negative impacts to their business prospects and, in a few cases, the outlook has been enhanced. One company, for example, is expected to benefit as a result of increased awareness of health, hygiene and safety while another is likely to have stronger cash flows as a result of the acceleration of the localization of supply chains, referred to as 'on-shoring'.

To be sure, the shorter term earnings of our recession exposed companies have been negatively impacted by the pandemic induced recession, but, in our view, none have been permanently impaired. The good news is that we often model a recession when we build our financial forecasts, so some of what has happened this year was already 'baked in' to our valuations. But we were not forecasting a pandemic and a recession as immediate and severe as that which we are in. So, while the Cash Flow Value (our term for intrinsic value)[1] of some of these companies has declined because of a loss of current earnings, the impact has not been as great as one might have assumed. And, in the past month, we have actually been taking our short term forecasts back up on many of our holdings given their better than expected reported results as well as our conversations with management.

In our Q1 commentary, we segmented our portfolio into three buckets in terms of the impact the pandemic and resulting recession would have on their businesses. Now with the benefit of hindsight, we recognize that our initial assessments were too negative in a number of instances. For example, we had originally assumed that one of North America's largest trucking companies would be modestly impacted by the pandemic. In fact, we actually saw an increase in our estimate of intrinsic value as a result of the pandemic – while certain segments were impacted negatively, others saw meaningful growth. Further, in a sign of its confidence in the resiliency of its business, the company resumed share repurchases in late May, after having paused them at the end of March. We had also assumed a manufacturer of commercial cooking equipment, residential kitchen appliances and industrial food processing equipment would have been impacted by the pandemic more than most. Again, we have been pleasantly surprised with how resilient their business has been. When we first hypothesized about the impact of the pandemic on their business, it resulted in a 7% reduction in the company's Cash Flow Value. Having seen their results

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through the first six months of the pandemic, we effectively reduced the pandemic impact in half and today, the company's Cash Flow Value sits only 3% behind where it was at the start of the year.

So, over the past seven months, having determined that our companies' balance sheets could weather even a severe recession and that none of our companies' prospects were permanently changed by the pandemic, we did what we always do in the face of changing traded prices – something we have come to term our Continuous Portfolio Optimization ("CPO") process. First, from late February until late March, we deployed the 'dry powder' which had been built up over the prior period in our various funds in the face of all-time high unit prices. Second, in each of our funds, we sold out of a few of our smaller positions (because they were trading very near to our estimates of intrinsic value) thereby reducing the number of holdings and we then deployed the proceeds into holdings that we thought were more attractively valued. Then, as the market stabilized in the second quarter, we redeployed some funds from those holdings whose share prices were recovering into other holdings where the share prices had not yet rebounded. By late May, we had completed the full evaluation of the companies we owned, determining, in each case, whether Cash Flow Value was higher, lower or unchanged, and so we turned our attention to the many companies we were closely following but did not own. The result of this evaluation over the past few months has seen four new companies added to Turtle Creek Equity Fund[2] (TCEF) to finish September with 28 holdings.

This brings us to how the companies we owned performed in the second quarter of 2020. Across the board, each company either met or exceeded the earnings expectations of both us and the market (generally surprising the market to the upside more than surprising us). We cannot recall a quarter where our companies exceeded expectations to such an extent. While that was nice to see, at the end of the day, it is only one quarter of results.

More meaningfully, we have been impressed with how our companies have handled the quickly changing environment. Across the portfolios, we believe our companies will come out of the pandemic induced recession stronger than they entered it. In some cases, the strength comes from outmaneuvering their competitors; in other cases, it comes from the increase in the number of acquisition opportunities at more attractive prices. Indeed, two of our largest holdings raised equity in the quarter. In both instances, the equity raises were done at prices that were higher than before the pandemic – in other words, they waited until their share prices had fully recovered. And, in both instances, the reason for raising additional capital was 'offensive' not 'defensive' in that they are seeing enhanced opportunities both organically and through acquisitions and so wanted to make sure they had the capital to take advantage of those opportunities. Many of our other holdings are also enjoying an attractive environment to deploy capital both organically and on acquisitions.

In this last part of our commentary, we turn to how our investment approach has served us well this year. Our approach entails four steps: 1. Find strong companies; 2. Develop an estimate of intrinsic value based on a balanced forecast of future cash flows; 3. Properly size a new holding; and, 4. Continuously rebalance the portfolio in reaction to changing share prices.

In step one, our goal is to own highly intelligent companies – those companies that are focused on driving shareholder value higher, through great operations and intelligent long term strategic thinking combined with smart capital allocation. They aren't always the largest company (although sometimes they are) but they're always the smartest. We believe building a portfolio from these highly intelligent companies is a great foundation and we have seen lots of evidence of it this year.

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Our second step, developing and maintaining a Cash Flow Value based exclusively on our forecast of free cash flow steers us clear of companies we follow that the market is currently fully or over valuing. Avoiding high flyers doesn't always benefit our shorter term unit price, but it definitely helps in the longer term.

We have not had much to do this year in step three – sizing new positions – until this quarter, where we added four new holdings to TCEF. None of them are yet large positions – they are simply cheap enough to make it into the portfolio – but in two of the four instances the share price drifted lower after we initially added them and we have taken the opportunity to buy more stock.

Our fourth step of Continuous Portfolio Optimization has resulted in an above average amount of activity this year. Indeed, our rebalancing activity is as high as it has been for a decade. CPO is a key component of our investment strategy and we believe it adds meaningful value over and above a 'buy and hold' investment approach. The first nine months of this year illustrate this well. If we had maintained a static portfolio since the beginning of the year, the Cash Flow Value of TCEF would be down about 2%. Not bad given our companies have had to deal with a pandemic and recession – it is testament to how well we think they have handled things. But TCEF's Cash Flow Value is up 9% on a year to date basis. The difference of 1,100 basis points to the better is from the rebalancing activities we have undertaken in the portfolio.

Quarterly Results

Unit price results:

During the quarter, the net asset value of TCEF increased 12.3%.[3] This was greater than increases of 6.1% for the S&P/TSX Completion index and 2.5% for the S&P MidCap 400 index (in Canadian dollars).[4] We added four companies and removed one to end September with 28 holdings. Approximately 44% of the portfolio was in Canadian companies with 56% invested in U.S. companies.

Turtle Creek United States Equity Fund ("TCUS") increased 15.0% during the quarter, significantly ahead of a 4.8% increase in the S&P MidCap 400 index (both in U.S. dollars).[3] We added two companies to the portfolio to end the quarter with 25 holdings.

Turtle Creek Canadian Equity Fund ("TCCF") increased 10.9% during the quarter, compared to an increase of 6.1% for the S&P/TSX Completion index.[3] We made no additions or removals to the portfolio to end the quarter with 26 holdings.

Intrinsic value results:

During the quarter we reversed some of the short term forecast reductions we had implemented because of the pandemic, based on Q2 results and discussions with our companies. As a consequence, our quarterly change in intrinsic value is as outlined below. The increases come from a combination of our companies nimbly dealing with the pandemic and our continuous portfolio optimization.

	TCEF	TCUS (US$)	TCCF
Quarterly change in intrinsic value	+5%	+6%	+10%

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 disclaim any intention 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. 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.
2. Turtle Creek Investment Fund maintains a portfolio that is almost identical to Turtle Creek Equity Fund.
3. Based on the change in net asset value of the fund's Class I Series 1.0 Units.
4. The S&P/TSX Completion (formerly called the S&P/TSX MidCap) is a Canadian total return index that is comprised of the constituents of the S&P/TSX Composite Index that are not in the S&P/TSX 60. The S&P/TSX 60 is a Canadian index that is comprised of the largest companies within the S&P/TSX Composite index. Previous commentaries made a comparison to the S&P/TSX Composite index rather than the S&P/TSX Completion 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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