Turtle Creek

Q1 2022

Quarterly Manager Commentary

A lot happened in the world this quarter. The most significant event was Russia's invasion of Ukraine and the ensuing humanitarian crisis. The war's impact on Ukraine's industries and farmers, together with the West's imposition of Russian sanctions, have triggered numerous commodity price dislocations – think oil, nickel, wheat – that are further contributing to inflation and supply chain disruptions. As well, COVID-19 continues to mutate to more contagious variants. While most of the developed world has been able to handle these waves without resorting to shutdowns, China's zero COVID strategy and relatively low rates of vaccination among seniors, have left them particularly vulnerable. China has responded with ever larger lockdowns, further exacerbating supply chain challenges. These factors have contributed to the highest inflation rates in a generation – gasoline, food, lumber, etc. are all at elevated levels. And on top of all this, central banks (led by the US Federal Reserve) have finally embarked upon the long-predicted tightening policy.

Simply put, there is uncertainty in the world. But it is easy to forget that there is always uncertainty – it's just the issues and challenges that keep changing. Our approach to uncertainty is to own leading companies across a broad collection of industries led by intelligent management teams, who, like us, are thinking about how they will react to a variety of future scenarios.

When we established Turtle Creek, we thought about the type of information we could provide to our investors on how the portfolio was doing in the shorter term. Using share prices to evaluate short term performance is simply not a good measure; which is why Turtle Creek has always tracked and published the change in Business Value (intrinsic value) for each of our funds.[1] We have written frequently about what Business Value is, so we won't repeat it (but, if you are interested, you can read about the methodology *here*). We are unique in our use of Business Value – we have yet to come across another investment manager that tracks and then publishes their portfolios' change in intrinsic value.

This quarter is a good example of the frequent disconnect between share prices and fundamental performance. During the quarter, Turtle Creek Equity Fund's ("TCEF") unit price was down 10%. And yet our companies, by and large, reported solid results. Based on our review of results and meetings with company management teams, we increased the Business Value of a number of our holdings. This, along with our ongoing rebalancing across the portfolio, combined to *increase* Portfolio Business Value in TCEF by approximately 10%.

One way to think about our Business Value is that it is the price someone would pay to purchase 100% of a company. Over the years, approximately 20 companies we owned have been acquired and, generally, the acquisition price has been at or above our estimate of each company's Business Value. A few recent examples will help explain this element of our investment approach.

The most recent acquisition example is a company that was only held in Turtle Creek Canadian Equity Fund ("TCCF"): Intertape Polymer Group Inc. Prior to the take-over announcement, the shares were trading at $22.50 as compared to our Business Value of $39. At the beginning of March, it was announced that a private equity group was purchasing the company at $40.50. The share price rose immediately to just below the offer price and we sold all of our shares.

A second example involves another Canadian company, Cineplex Inc. In late 2019, Cineworld, based in the United Kingdom, announced it was acquiring Cineplex for $34 per share. At the time, Cineplex was a small (1.5%) holding in TCCF. Our Business Value was $26 and, with the shares trading above the announced takeover price, we sold all our shares that day, as we thought a higher offer was

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unlikely. When the pandemic hit, Cineworld reneged on its offer and Cineplex remains a public company. Cineplex is suing Cineworld and the matter continues to wind its way through the courts (with Cineplex winning the first round).

Interestingly, just over a year before the announcement of the takeover, TCEF sold all its shares of Cineplex at $34 per share in September 2018. It was a small holding at the time (less than 2%) and, as we added a new holding with a larger discount to Business Value, we removed Cineplex to maintain a fixed number of holdings. Over the prior couple of years, we had been reducing our estimate of Business Value, based on new information, from the $40's down to the $30's by the time we sold our position. This underscores a key point about our Business Values – they can be reduced as well as increased. We constantly strive to maintain a balanced forecast based on all available information and, while our forecasts generally increase over time, there are lots of examples, like Cineplex, where they go the other way.

The final example is Welbilt Inc., a company we had followed for years, but only added to our portfolio in mid-2020. As with many companies, its share price declined significantly in the March 2020 COVID Crash, falling by more than two-thirds. But whereas the share prices of many of the companies we owned quickly rebounded, Welbilt's share price was still at a low point months later. By July of 2020, the stock was relatively attractive, so we added it to both TCEF and Turtle Creek United States Equity Fund at around $6.50 per share.[i] During the last quarter of 2020, the share price rose into the low teens, during which time we trimmed the position by half. In April of 2021, Welbilt announced it had agreed to sell to Middleby Corp. in an all-share transaction (interestingly, Middleby is one of our larger holdings). On May 28th, the Wall Street Journal reported that a private Italian company had approached Welbilt with an all-cash offer of $23.00 per share. The market reacted quickly, spiking Welbilt's share price above $24 on speculation the bid was credible and would spur Middleby to increase its takeover price. Given our Business Value was $21.75, and the shares were trading more than 10% above our Business Value, we sold all of our shares the day of the article. Our judgement was that Middleby would have the discipline to avoid paying an excessive price for Welbilt, and we were correct in this assessment – they chose to collect their $110 million 'break fee' and focus on other opportunities. The Italian company did raise their offer in July of 2021 to $24.00 per share, but this was still below the price we realized the day of the initial announcement. And while the acquisition has yet to close, no one has come forward with a higher offer.

The Welbilt example illustrates a couple points:

Firstly, the market can be *incredibly inefficient* at times. Let's ignore the immediate impact of the COVID crash when the company traded as low as $3.50 per share. Here's a company that throughout the middle of 2020 was trading in the mid single digits. At that time we managed to assemble a significant stake in the company at an average price of $6.50. And then a mere six months later, the company was sold for nearly four times the price we paid. Of course, the Business Value of the company was unchanged in this short period. But the traded price was clearly disconnected from reality.

Secondly, smart companies don't have to engage when someone comes knocking. In June of 2020, with the shares trading at $6, a private equity firm approached Welbilt with an offer to buy it for $12 – $13. The company concluded it was not worth considering this offer which would have had them initiate a sale process; and that instead the best course for their shareholders was to focus on their

i. Welbilt prices are shown in U.S. dollar.

long term strategy. But around the same time, Middleby approached Welbilt to discuss a possible all-share transaction. In this case, Welbilt agreed to enter into discussions, which resulted in the proposed all-stock, but unconsummated, acquisition by Middleby that was at our Business Value.

We never invest in a company with the hope that it will be acquired. Indeed, we generally don't expect our companies to be acquired as they tend to be the ones that do the acquiring. But in the instances where they have been bought, as in the three examples provided above, the takeover price has provided a strong validation of our Business Value work.

We mentioned earlier that *one* way to think about Business Value is the price to buy 100% of a company, but a *better* way to think about our Business Values is with the following analogy: that each company's share price is 'tethered' to its Business Value by a rubber band. The further away from Business Value the share price drifts (in either direction), the stronger the pull back toward Business Value. While the drifting apart can continue over long periods and the gap can sometimes become quite large, there are forces that inevitably come into play that help to narrow the gap. A sale process (such as described above) is one such force. Another force is share buybacks whereby a company purchases and cancels their shares at attractive prices. Today, 75% of our portfolio is comprised of companies that are actively buying back their shares. They have the balance sheet liquidity and inclination to be active. And this was based on their activity from a few months ago. With the market selloff and the share price declines of some of our holdings, we are pretty sure they have been even more active recently.

Quarterly Results

Unit price results:

During the quarter, the net asset value of the Turtle Creek Equity Fund ("TCEF") declined 10.4%.[2] This was well behind the S&P/TSX Completion index which increased by 5.2% and also behind the S&P MidCap 400 index which declined 6.2% (in Canadian dollars).[3] We made one addition and one removal, to end the quarter with 30 holdings.[4] Approximately 68% of the portfolio was invested in U.S. companies with 32% in Canadian companies.

Turtle Creek United States Equity Fund ("TCUS") declined 10.8% during the quarter, compared with a 4.9% decline in the S&P MidCap 400 index (both in U.S. dollars).[2,3] We made no additions or removals to the portfolio to remain at 25 holdings.

Turtle Creek Canadian Equity Fund ("TCCF") declined 7.2% during the quarter, versus a 5.2% increase in the S&P/TSX Completion index.[2,3] We made no additions or removals to the portfolio to remain at 25 holdings.[4]

Business Value results:

While our unit prices were down in the quarter, our Business Value pulled the other way – up 10% for TCEF.

	TCEF	TCUS (US$)	TCCF
Quarterly change in Business Value	+10%	+11%	+2%

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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. 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 a 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 inherently uncertain and subject to a number of risks that may cause the actual results of Turtle Creek Equity Fund (“TCEF”), Turtle Creek Investment Fund (“TCIF”), Turtle Creek Canadian Equity Fund (“TCCF”) or Turtle Creek United States Equity Fund (“TCUS”) (each, a “Fund”) 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 “Certain Risk Factors”. Any forward-looking statement speaks only as of the date 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 placed thereon.

Endnotes

1. A company’s intrinsic value or Business Value represents our best estimate of the present value of such company’s future cash flows 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 Business Value is calculated using our estimate of Business Value for each company, weighted based on the portfolio’s holdings.
2. Based on the change in net asset value of the Fund’s Class I Series 1.0 Units.
3. 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. 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 U.S. stock market by capitalization. The S&P MidCap 400 index is a total return index. Returns for all indices are shown in Canadian dollars unless indicated otherwise. 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.
4. Holdings that constitute less than 0.25% of the Net Assets of TCEF are not included in the number of holdings. Similarly, holdings that constitute less than 0.1% of the Net Assets of TCCF and TCUS are not included in the number of holdings.

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