September 30, 2015

Value Investor INSIGHT

The Leading Authority on Value Investing

Standing Out

Andrew Brenton isn't afraid to take management at its word, a sound strategy given how skilled he's proven at deciding who deserves that kind of trust.

INVESTOR INSIGHT

Andrew Brenton
Turtle Creek Asset Management

Investment Focus: Seeks uniquely positioned companies – run by uniquely skilled managers – when their stocks trade at seemingly run-of-the mill prices.

Don't expect Andrew Brenton to spend time trying to decipher the market's intentions. "Our view is that the market is terribly inefficient and companies are mispriced most of the time," he says. "So we don't see the benefit of trying to figure out what the market thinks."

Keeping their own counsel has served Brenton and Turtle Creek Asset Management co-founders Jeff Cole and Jeff Hebel remarkably well. Since 1998 the firm has earned an eye-popping net annualized 25.7% return, vs. 7.1% for equal weightings in the S&P 500 and S&P/TSX indexes.

Focused on companies with "big, rational ambitions," Brenton currently sees opportunity in such areas as specialty foods, factory automation, mortgage lending, trucking and software. See page 2

Logical Conclusion

Patient investors are often deemed unable to react quickly, says Michael Cook, whose success would indicate that the opposite is closer to the truth.

There's nothing fancy about Michael Cook's investing approach, in which he emphasizes attention to detail, sticking to one's knitting and the need to rely on facts and logic over assumptions and hype. "Employ these values in almost any endeavor and they should translate reasonably well to good outcomes," he says.

The outcomes have certainly proven good for Cook's SouthernSun Asset Management investors. The firm's flagship small-cap strategy since 1990 has earned a net annualized 12.3%, vs. 9.4% for the Russell 2000.

Targeting smaller companies with big profiles in their businesses, he's finding opportunity today in widely diverse areas such as consumer electronics, automotive supply, industrial infrastructure, recreational vehicles and underwear. See page 11

INVESTOR INSIGHT

Michael Cook
SouthernSun Asset Management

Investment Focus: Seeks companies whose dominance in niche markets, financial strength and management adaptability are being misjudged by the market.

Inside this Issue

FEATURES

INVESTMENT HIGHLIGHTS

Investor Insight: Andrew Brenton

Andrew Brenton of Turtle Creek Asset Management explains how the companies he favors are "highly-intelligent," why he holds a fixed number of positions, to what he attributes a meaningful part of his firm's market-trouncing performance, and why he sees mispriced value in Premium Brands, ATS Automation, Home Capital, TransForce and Open Text.

Describe the characteristics of companies that attract your attention.

Andrew Brenton: We're looking for highly intelligent companies that understand the environment in which they operate, that out-think and out-maneuver their competitors, and that focus on maximizing shareholder value even if that means – in a declining industry – harvesting capital from their business and returning it to their shareholders.

We own companies that are in high-growth sectors, companies in mature industries and even a couple of companies in declining industries. But regardless of the industry backdrop, they often have what we call big, rational ambitions. They pick their spots, press their advantage when they have it, and know when to pull back due to a poor environment or irrational competitors. Probably two-thirds of the fund by value today is in companies where growth through well-integrated acquisitions is a key part of their strategy.

To us it's very much about the people. The CEO of Premium Brands [PBH:CN], George Paleologou, took charge of a commodity pork producer in the prairies of Canada many years ago, exited commodity businesses and has gone about building a remarkable business focused on specialty foods where purchasing decisions are based on factors other than price – namely quality, convenience, health-consciousness, sourcing and brand recognition. He buys into strong regional operators and then, often in partnership with the company founders, helps them scale and improve their businesses. Given the opportunity set, we think he's just getting started.

Another example: In 1996 Alain Bédard took over a near-bankrupt Quebec-based trucking business with maybe C$100 million in revenue. He's since made over 100 acquisitions and his company, TransForce [TFI:CN], is 40 times bigger by revenue and a strong operator across trucking and delivery segments in Canada and the U.S. We've yet to come across a CEO with a better command of his business or who is more opportunistic and flexible in managing capital for shareholder benefit.

We gravitate toward companies with relatively long management tenure. It sounds obvious, but you can look at what they've done. How did they manage through this rough patch? How did they integrate that acquisition? How did they respond to that competitor? Much of our research is around understanding history and context, not unlike piecing together a well-written story. We're looking simply for operational excellence and great capital allocation, which are hard to find in the same place.

The last thing I'd add here is that while a lot goes into deciding where we place our trust, once it's there we're not trying to recreate the wheel about what the company can and should do – we're typically taking management at their word and we're counting on them to deliver. That's why one early check for us is to make sure the company's business model isn't at all predicated on raising additional equity capital from the market. When they don't need treasury money from us, we're more likely to get the straight goods.

What is your circle of competence?

AB: Our universe is the approximately 1,900 companies listed on North American stock exchanges with market capitalizations between $1 billion and $25 billion. Within that range we've found no correlation between market cap and market efficiency. We actually don't consider the market very efficient, period.

Primarily due to the fact that we're based in Toronto, the large majority of our investments have been in Canadian-headquartered companies. Of the 80 com-

Andrew Brenton

Going Public

After successful stints as an M&A investment banker and as the founding CEO of a bank's private-equity subsidiary, Turtle Creek Asset Management's Andrew Brenton sat down one weekend in the late 1990s and wrote out what turned out to be 13 reasons he thought investing in public equities was the better way to go. "Think of all the issues you have to deal with in private equity," he says. "Deal sourcing, intense competition, the fact that you can do months of due diligence on what you believe is a great opportunity and very often the owner decides he doesn't need your money or goes with someone else. In the public market, you do your research and can simply put capital to work if you like the investment at the price. You don't have control, but if you can identify terrifically run and terrifically governed companies, that doesn't matter."

In pursuit of his new strategy, Brenton in 1998 joined with his private-equity colleagues Jeff Cole and Jeff Hebel to launch Toronto-based Turtle Creek. Seventeen years later, he says public-equity opportunities remain as plentiful as ever: "An incredible feature of public markets is how broadly company stock prices move relative to company business values. We do our best to try to take advantage of that."

panies we've owned since starting out in 1998, 70 have been based in Canada and 10 in the U.S. But differentiating by head office is really an artificial distinction. Most of our companies generate far more business outside Canada than in it. We also wouldn't say Canadian stocks are less efficiently priced than those in the U.S., and as we've worked our way through small- and mid-cap Canadian companies, we're naturally spending more of our time looking for comparable opportunities in the U.S. Our working list of prospective names today is probably half U.S. based.

One area we've always excluded is the resource sector. We don't own oil-and-gas companies. We don't own mining companies. Some people find this surprising because we're based in Canada, but we've never figured out what comparative advantage we might have that would make investing in those areas worth our time.

Can you give an example of something attracting your attention in the U.S.?

AB: TJX Companies [TJX], which operates retail banners including T.J. Maxx, Marshalls and HomeGoods, is interesting. We know them in Canada where they've done a terrific job in building the business through acquisition. As management describes it, people in every culture want a deal, so they believe they have considerable opportunity to expand their off-price retailing concepts to new countries. Based on our work so far the stock isn't nearly as cheap as many of our other holdings, so we own a very small position today. But it's the type of business we could own more of as we do additional work, especially if it becomes cheaper.

Describe your idea generation.

AB: We never run screens. We've actually tried to go back and construct screens that would have reliably identified the companies in which we've invested, but we haven't been able to do it. Because of accounting rules, there are always enough anomalies in the numbers that screens too often reject companies where we might think the business is a lot better than the reported numbers indicate.

Our ideas come from talking and reading about companies, trying to put together that narrative I described earlier that signals highly intelligent organizations. We talk with experienced research analysts who "get" what we're looking for. We go to institutional lunches and conferences to hear management speak about their businesses. When we dig in, we want to spend a lot of time with management. It takes a long time for us to know something well enough and be comfortable with it. We have to get to that point first before we pay much attention to valuation, so it's rare that we start to look into something just because it appears cheap. Without digging in, it's difficult to actually know whether a company is cheap.

ON IDEA GENERATION:

It's rare that we start to look into something just because it appears cheap. Without digging in, it's hard to know.

We meet with companies even when we have little intention of diving in right away. Often management has turned over recently and we don't have enough history to go on, but we want to meet the CEO and hear the story. Who knows down the road what might prove useful?

A number of years ago we met with the CEO of Badger Daylighting [BAD:CN], which provides excavating services using its in-house-built "hydro-vac" trucks – think high pressure water and a powerful vacuum. It's an alternative or complement to using picks, shovels or backhoes to dig. The CEO talked about how this technology, which was widely used in the Western Canadian oil patch, could be used in Eastern Canada by contractors to avoid damaging buried utility lines, a new market that would allow him to expand the business. We took copious notes but didn't think it was right for us at the time.

A year or so ago when a local investment firm flagged Badger again for us and wanted to set up a meeting with the CEO, we looked over our previous notes and what had happened in the interim, and by gosh if he hadn't done everything he said he was going to do. This time we dove even deeper and became convinced that the company could consistently out-execute its competition. It also has a significant long-term opportunity to expand both geographically and into new sectors beyond oil and gas, a legacy that we believe is unjustly hitting the share price. [*Note*: Badger shares, at a recent C$19.25, have fallen by 55% in the past 18 months.] This is an example of a company we've known for some time, but only added it to the portfolio in the past year. As the share price has declined it has more recently become an overweight position.

Describe how you turn a company "story" into an assessment of value.

AB: We build for each of our companies what become complicated financial models that are meant to represent our best view on the future at every point. The real value in doing all the modeling work is that it consolidates a great wealth of historical information and makes us explicitly consider all crucial assumptions that will affect the future of the business, guarding against untested speculation and optimism. We think probabilistically, recognizing that the world is complicated and uncertain. If you think of potential outcomes as some kind of bell curve, we're trying to get to the 50% percentile.

The present value of all the future cash flows of the company is ultimately the only thing we care about. We use a 9.5% discount rate, so if we buy a company's shares at our intrinsic value and our forecasts turn out to be accurate, we should earn about 9.5% per year over the long term. The end result of all this is an apples-to-apples cash flow forecast for each of our companies, generating a net present value that we think roughly coincides with the price a buyer would pay for the entire entity. That's our intrinsic value. The lower the price we pay below intrinsic value, the higher the long-term expected annual return is above 9.5%.

We earn our returns from the cash our companies are going to make and pay out to shareholders. We're not at all counting on the market to "recognize" value.

What's the hurdle to get into the portfolio?

AB: We always hold 25 stocks, so the hurdle is having one of the best 25 expected returns.

Why 25 holdings?

AB: The number was driven initially by how many companies we felt we could know at any given time. We also believe that once you own 25 companies in industries unrelated to each other, with each company facing its own unique opportunities and challenges, you are substantially as diversified as portfolios containing hundreds of companies. This is where we have all our money and knowing what we own – which often means being comfortable to buy more when something is falling in price and other people are running the other way – is the best risk control.

Sticking right at 25 also disciplines us to make sure we're always trying to optimize the portfolio. Once we own something, position size is driven primarily by expected return from today's price, but we also consider other factors like quality of management, how well we believe we understand the business and how broad or narrow we consider the range of possible outcomes. If we thought everything in the portfolio was equally attractive, we'd have 4% in each. But that's never been the case. Today our biggest holding is 12% and our smallest just under half a percent. Again, it's primarily a function of price: We might think the half-a-percent holding is a better company than the 12% one, but at current prices the expected return of the bigger weighting is far more attractive than that of the smaller weighting.

People ask me all the time what are our highest-conviction ideas. I answer that all of our ideas are high conviction. Some just happen to be priced highly by the market and we therefore don't own very much.

Do you ever hold cash?

AB: We don't believe as a general rule that it's possible to forecast the direction of the stock market in the short term. So as long as we can find companies that are generating strong cash flows, have excellent growth prospects and are trading below intrinsic value, we're likely to be more or less fully invested.

ON OUTPERFORMANCE:

A big part comes from owning a little bit of terrific companies when they're fully priced and a lot when they're cheap.

There have been a few periods of high valuation, primarily in 1999 and early 2000, when we weren't fully invested because expected returns on some of our holdings didn't offer a superior risk/return proposition relative to Treasury bills. But that was an anomaly. We own a couple of companies in the portfolio today that trade a bit above intrinsic value, but the risk-adjusted expected returns versus Treasuries are still highly positive. The position sizes are small, but we own them.

You consider what you call "continuous portfolio optimization" to be an important factor in your outperformance over time. Describe what that is.

AB: It's essentially what I spoke of earlier about our multi-factor model for determining position sizes. We have a buy-and-hold mindset in liking to own high-quality companies with strong management teams as they compound future cash flows, but we're very disciplined in continuously responding to changing stock prices – trimming positions in companies as they come into other investors' favor and adding to positions as they go out of favor.

I'm picking an especially positive example, but to give you an idea of the difference this can make, we've owned almost continuously since mid-1999 a position in Open Text [OTC:CN], an enterprise software company. Had we bought an initial position and never traded around it, we would have earned a quite respectable annual return of 12%. But by responding to volatility in the share price as it overshot and undershot intrinsic value, our return – over 60% per annum – has been more than five times the buy-and-hold return.

We're not responding to every little day-to-day movement, but we are quite active. In fact, we plan out a trading strategy for each of our positions that allows us to react calmly during times of market dislocation. In what until recently have been relatively calm markets in North America over the last few years, our annual turnover in terms of number of shares traded divided by total shares owned has been 35-50%. We don't know exactly how to measure it, but we believe a meaningful part of our long-term outperformance has been from owning a little bit of terrific companies when they're fully priced and owning a lot when they're cheap.

You spoke earlier about stepping up to buy when other people are running the other way. Are you in that situation often?

AB: I mentioned that we've owned 80 companies over our 17 years. If you look at the 35 or so that have been overweight in the portfolio, in every single case we initially lost money. Part of that is definitional – the only way something becomes a big holding is if it falls further in price and we buy more. But yes, we're in that situation often. I'd add that in each of those 35 positions we ended up making money.

A share-price decline is a great test for an investor. If you don't want to buy more or are disappointed and wonder if you should sell, then you never should have owned it at the higher price. We regularly ask ourselves if the price of one of our investments were to drop, would we be happy to buy more? If the answer is no, we should be reducing the weighting today.

Describe in more detail how Premium Brands is an intelligent company.

AB: It's a combination of strategy, execution and capital allocation. They identify specialty food businesses that fit their profile and then look to do deals with the founders who still run the business. The founders may be starting to plan for an orderly transition, or may want to diversify their net worth, or may simply recognize that they can expand their business faster by teaming up with Premium, which has a reputation as a great partner. Premium wants its acquired companies to grow and it has the operational expertise and resources to help make that happen.

As an example of the strategy, Premium recently bought a majority interest in Expresco Foods, a $55 million annual revenue business that was started by two guys in Montreal who figured out an innovative way to prepare grill-fired, pre-cooked shish kabobs and satays and then sell them into foodservice and retail channels. At the same time Premium expects to use its U.S. and Canadian marketing and distribution infrastructure to help the company expand, it also believes Expresco has products and expertise that can help its other brands. We think they paid around 6x EBITDA for about 70% of a business that they believe has a long runway of low-double-digit annual organic growth. As soon as the deal was announced competitors called up saying, "We've been trying to get these guys to sell for three years, how did you convince them to do it?"

George Paleologou is a remarkable judge of both talent and business potential. Going back five years, Premium paid something like $42 million to buy SK Food Group, a maker of artisan breakfast sandwiches based in Washington state. George had identified sandwiches as an attractive segment and Premium was already Canada's largest sandwich maker. Buying SK would make it the largest player in North America. Since the acquisition, SK has grown dramatically and has become one of Starbucks' largest suppliers. It's still going strong, recently opening a new plant in Columbus, Ohio partly to serve new quick-service-restaurant clients and also to handle Starbucks' increased demands.

How are you looking at valuation with the shares trading today at C$31.30?

AB: Most of our companies report using IFRS [International Financial Reporting Standards] rather than U.S. GAAP [Generally Accepted Accounting Principles], which especially for acquisitive companies like Premium can be a bit of a mess. We always focus on cash earnings, which we believe this year will be north of C$3 per share and within a couple of years will be close to C$5. That makes the shares today quite cheap, especially given the growth we're expecting. The dividend yield is also attractive, at 4.3%.

Cash-flow growth is coming here from a variety of areas, including organic unit growth, pricing power, declining input prices for things like pork and beef in the short- to medium-term, and continued acquisitions longer-term. Factoring all that in we arrive at an intrinsic share value in the low-C$60s. It's one of the smaller market cap companies we own, but is currently our second-largest position.

What attracted your interest in ATS Automation Tooling Systems [ATA:CN]?

AB: This is a great example of a company we got to know years ago but did not invest in initially because we didn't find it attractive enough. ATS's core business is in factory automation and it has a reputation

INVESTMENT SNAPSHOT

Premium Brands
(Toronto: PBH:CN)

Business: Holding company for specialty food businesses selling a variety of packaged foods to retail and foodservice customers primarily in Canada and the U.S.

Share Information
(@9/29/15, Exchange Rate: $1 = C$1.341):

Price	**C$31.30**
52-Week Range	C$22.01 – C$34.60
Dividend Yield	4.3%
Market Cap	C$793.2 million

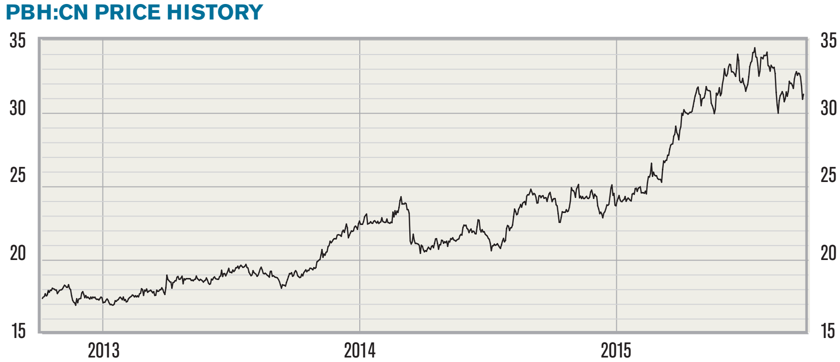
Financials (2014):

Revenue	C$1.24 billion
Operating Margin	4.9%
Net Profit Margin	0.9%

Valuation Metrics
(@9/29/15):

	PBH:CN	Russell 2000
P/E (TTM)	n/a	81.7
Forward P/E (Est.)	14.5	17.0

PBH:CN PRICE HISTORY



THE BOTTOM LINE

Focused on acquiring food businesses that compete on factors other than price and then providing them with the operational expertise and resources to expand, the company has a long growth runway ahead, says Andrew Brenton. Factoring in organic and acquired growth as well as pricing power, he estimates intrinsic share value in the low-C$60s.

Sources: Company reports, other publicly available information

in the industry for expertise in tackling tough problems, like trying to figure out how to refurbish a nuclear reactor with a minimum of down time. It was founded by a German engineer who had moved to Canada and it's always been steeped in a strong engineering culture.

We first met with management in 2003 and weren't impressed with the strategy. The founder was quite sick and while the company clearly had some great customer relationships helping Fortune 500 firms make their production processes better, it struck us as rather unfocused and meandering. They had bought a solar plant in Lyon, France, for example, which didn't seem at all like a good idea.

We started paying attention again in 2007 when Anthony Caputo was named CEO. He was someone we'd known and respected and so we met with him soon after he joined, and he described all the things he was going to do to fix the company and grow it. We thought he was a smart guy but it all seemed like a lot of work, so we waited and watched. Over the next 15 months we saw him do exactly what he said he would do and results were starting to improve. We bought our first shares in January of 2009 at around C$5, and promptly watched them go to C$3 in the first three months. As I said often happens, we used the price decline to significantly add to our stake and by that April it was our largest holding.

There were several aspects to the company's renewal. They see a positive secular trend toward automation, driven by customers' ongoing push to improve manufacturing efficiency, eliminate labor costs and improve quality control. To capitalize on that, the CEO has been focused on creating domain expertise both by industry and by type of manufacturing process. They've done a good job using acquisitions to buy capability and we expect that will continue in what is still a mom-and-popish industry. The solar business, by the way, is gone.

There's also been a fundamental change – which is still a work in process – in how the company looks to engage with its customers. As Caputo describes it, when he took over, the company had worked for years with Gillette. Every time Gillette needed a new machine that could put, say, five razor blades in a razor rather than four, it would ask ATS. ATS would get to work, deliver on the project and then wait until the next time Gillette needed something new. Now the company tries to engage at a level where it goes to Gillette and says, "We know Procter & Gamble, your parent, thinks you should be making your razor blades in China, but have you ever looked at the total cost of doing that versus better automating the process and continuing to make blades along the waterfront in Boston? We can help you do that." That's an actual example, and describes more of a partnership approach toward longer-term enterprise solutions. The more successful ATS is in partnering this way, the stronger its competitive advantage will be.

It's also very interesting when they talk about changing culture. The CEO says he has a lot of great engineers, but they were much better at responding to 50-page requests for proposal than actually sitting down with customers to understand their businesses better and see what they might need beyond the 50-page document. One thing he did was hire business-development people to have that conversation and then create in-house their own 50-page documents that the engineers could better relate to. Rather than trying to change the engineers or just say "do this," the organization was adaptable in finding a solution that accomplished the ultimate goal.

INVESTMENT SNAPSHOT

ATS Automation Tooling Systems
(Toronto: ATA:CN)

Business: Provider of automated manufacturing and assembly systems for customers in the consumer products, energy, life sciences and transportation industries.

Share Information
(@9/29/15, Exchange Rate: $1 = C$1.341):

Price	**C$12.51**
52-Week Range	C$11.90 – C$16.60
Dividend Yield	0.0%
Market Cap	C$1.16 billion

Financials (FY ending 3/15):

Revenue	C$936.1 million
Operating Margin	7.2%
Net Profit Margin	5.9%

Valuation Metrics
(@9/29/15):

	ATA:CN	Russell 2000
P/E (TTM)	20.8	81.7
Forward P/E (Est.)	12.5	17.0

ATA:CN PRICE HISTORY

THE BOTTOM LINE

Andrew Brenton believes the company has robust growth ahead of it as it benefits from a positive secular trend toward automation and from an evolution in sales culture from a task orientation to one focused more on longer-term enterprise solutions. Assuming multi-year 20% profit growth, he arrives at an intrinsic value estimate in the high-C$20s.

Sources: Company reports, other publicly available information

How do you see all this translating into upside for the shares, now at C$12.50?

AB: As I mentioned, we don't go off in isolation and try to invent the future. We talk to our companies and assess what they believe they can do. Can they achieve that level of organic growth? Will traction with enterprise solutions drive that much new business? Can they get paid more for the value they believe they provide?

All of this folds up into what might appear to be very ambitious growth, but when we break it down it's quite reasonable. With mid-single-digit organic revenue growth, improving operating margins and continued acquisitions, we believe over the next seven or eight years the company can grow its bottom line 20% per year. The stock isn't optically cheap, trading at around 11x trailing EBITDA, but when we discount our estimate of future cash flows we arrive at an intrinsic value in the high-C$20s. The level of growth expected here might scare some investors away, but we've learned not to be afraid to forecast growth when we think it's there.

There's controversy around your next idea, Home Capital Group [HCG:CN]. How are you seeing through that?

AB: Gerry Soloway, a former real estate lawyer, took over as CEO of Home Capital in 1987. He had identified certain segments of mortgage customers, namely successful entrepreneurs or fairly recent immigrants to Canada, that were being turned away by the increasingly automated loan processes at the big, lumbering Canadian banks. He started Home to serve them and has built it into Canada's largest alternative mortgage lender by far. While it has a trust license, it has to comply with all the regulations for banks in Canada.

Home originates prime mortgages which are securitized and sold off, but the driver of value is non-prime mortgages which are retained on its balance sheet. Their primary customers are new immigrants who lack a Canadian credit history, and the self-employed, for which the larger banks are not willing to do the extra work required to substantiate income. The underwriting process is very disciplined, with loans made against double appraisals done by approved appraisers, and with down payments typically of 25-30% in cash.

The loan-loss experience has been better than at the big banks, a function of maintaining low loan-to-value ratios and of selectivity in where and when it lends. It stays away from rural areas, for example, preferring cities with homes that are similar to others on the street and can be sold quickly if there is a problem. Because of the lack of recourse to the borrower in Alberta, it's more cautious with its loan-to-value ratios there. In Saskatchewan, where legislation is even friendlier to delinquent borrowers, Home chooses not to lend. That kind of discipline has resulted in 20%-plus returns on equity over time.

When we were first digging into this around the financial crisis, we'd meet industry experts who criticized the company for shifting more of its lending from subprime to prime. When we asked management about it, they simply said they were able to write insured prime mortgages at the same spread as they could write subprime, so why wouldn't they do so? When we talk about intelligent companies, that's the type of thing we mean.

Is the market opportunity still growing?

AB: If you think of the customer base as primarily immigrants and the self-employed,

INVESTMENT SNAPSHOT

Home Capital Group
(Toronto: HCG:CN)

Business: Canadian trust company offering deposit and lending services; lending specialty in "Alt-A" mortgages with perceived risk profile between prime and subprime.

Share Information
(@9/29/15, Exchange Rate: $1 = C$1.341):

Price	**C$32.33**
52-Week Range	C$25.50 – C$55.72
Dividend Yield	2.7%
Market Cap	C$2.27 billion

Financials (2014):

Total Assets	C$20.08 billion
Revenue	C$1.01 billion
Net Profit Margin	30.9%

Valuation Metrics
(@9/29/15):

	HCG:CN	Russell 2000
P/E (TTM)	7.2	81.7
Forward P/E (Est.)	7.5	17.0

HCG:CN PRICE HISTORY

THE BOTTOM LINE

The current valuation of the company's shares reflects what Andrew Brenton believes is an unjustified pessimism around the Canadian residential real estate market and the credit quality of the firm's mortgage-loan portfolio. Calling it the "highest-expected-return stock we own," he estimates intrinsic value at more than double today's share price.

Sources: Company reports, other publicly available information

those groups as a share of the mortgage market are definitely growing, especially in Home's biggest market, which is the greater Toronto area. Out of the roughly C$1 trillion Canadian mortgage market, we'd estimate the addressable subset for Home at closer to C$100 billion. It has maybe 12% of that market today and we believe due to its scale and relationships with mortgage brokers that that share can get to the mid- to high-teens.

One of the governors on growth has been the regulator in Canada tightening the rules on things like income verification in an ongoing effort to prick a little bit of air out of the real estate market. While that causes Home to lose some business to unregulated players, at the same time it allows it to get some business that it otherwise wouldn't that the big banks no longer write. Overall we think the Canadian regulators have done an excellent job, so having to adjust to new standards at the margin isn't a high price to pay.

Home's short interest as a percentage of its float is 25%. What's the bear view?

AB: Some U.S. hedge funds appear to have concluded that if you look at certain mortgage-debt and home-price metrics in Canada that there are parallels to pre-financial-crisis levels in the U.S. and that the other shoe is about to drop. When we make adjustments for how things are defined and reported to arrive at apples-to-apples comparisons, we think the numbers are far less concerning.

There also appears to be specific concern that Home has a high percentage of liar loans and is misrepresenting its credit quality. It didn't help that there was fraud uncovered recently at a large mortgage-brokerage in the Toronto area that appears to have falsified income for some clients that had applied for insured prime mortgages. In that specific case, Home cut off a number of brokers and hasn't seen any unusual loss or arrears experience on the loans in question. More generally, we trust management and believe the numbers they report, which don't indicate any real problems with credit quality.

The shorts so far appear to have the upper hand – the shares, in the mid-C$50s less than a year ago, now trade at around C$32. Have you been buying?

AB: This is the highest-expected-return stock we own and our estimate of intrinsic value is well more than double the current share price. When the stock in the past few months went from the mid-C$40s to as low as C$26, we almost exactly doubled the amount of shares we own. It's now one of our largest holdings.

Why are you still high on TransForce's prospects?

AB: There's nothing particularly unique about the basic business. As I mentioned, the company started out as a small less-than-truckload carrier and has methodically over time expanded beyond that. It's now the largest trucking company in Canada. It's big in parcel delivery. It's one of the largest same-day expedited delivery companies in the U.S. It's building a U.S. truckload business. It's even in the landfill business in Eastern Ontario and Quebec.

What is unique is Alain Bédard, who is a remarkable capital allocator and a first-class operator. He has tremendous command of the business and the numbers and is very clear-headed and rational in explaining what he's doing and why. In one conference call someone asked about using caps and collars on fuel surcharges and he explained he didn't like them. If fuel prices go up and exceed the cap, he

INVESTMENT SNAPSHOT

TransForce
(Toronto: TFI:CN)

Business: Through a network of wholly-owned operating subsidiaries provides a range of freight transportation and logistics services to North American customers.

Share Information
(@9/29/15, Exchange Rate: $1 = C$1.341):

Price	**C$23.45**
52-Week Range	C$20.12 – C$31.60
Dividend Yield	2.8%
Market Cap	C$2.36 billion

Financials (2014):

Revenue	C$3.26 billion
EBIT Margin	8.4%
Net Profit Margin	4.7%

Valuation Metrics
(@9/29/15):

	TFI:CN	Russell 2000
P/E (TTM)	14.9	81.7
Forward P/E (Est.)	11.3	17.0

THE BOTTOM LINE

Company CEO Alain Bédard has a unique command of his business and has dramatically expanded it over time through opportunistic capital allocation, says Andrew Brenton. Assuming 10-12% annual revenue growth and a return to pre-crisis margin levels over the next few years, Brenton estimates the stock's intrinsic share value in the high-C$40s.

Sources: Company reports, other publicly available information

has to eat the excess amount. But if prices fall through the floor, or collar, customers say they want the full lower price or they'll take their business elsewhere. There have also been questions on trucking competitors adding rigs in response to higher demand and he says he'd always prefer first to raise prices, then think later about adding rigs. These may seem like little things, but they add up to give us confidence he will do the right thing.

We also like that he's opportunistic and responds to what's in front of him. A few years ago he said he'd never go into long-haul trucking in the U.S., but he ended up buying a decent-sized U.S. truckload business because he thought there was an opportunity to take advantage of the increasing north/south trade flow in North America, including Mexico, and he couldn't do that with just a Canadian piece. He also thought the management of the U.S. company was extremely capable and could eventually take on a bigger role in the entire company.

While he's been adept at acquisitions and we consider that to be the primary avenue for growth going forward, we're also comfortable that he'll sell if the opportunity presents itself. TransForce has been aggressive in expedited-delivery in the U.S., which is a different animal, much more about guys in bikes and cars running around delivering things than all the technology and logistics involved in overnight delivery. He sees a chance to consolidate the business, but if things get frothy as the craze for e-commerce and immediate delivery goes on, he's probably more likely a seller than a buyer.

Now trading at just around C$23.50, how are you valuing the shares?

AB: We're assuming very little organic growth, but we think revenues can increase 10-12% per year for the next number of years as a result of acquisitions. We also think operating margins, as acquisitions both old and new are integrated, can get back to their pre-crises levels above 13%. Working through the model we arrive at an intrinsic value estimate in the high-C$40s. It's an overweight position for us.

From trucking to software, describe your investment case today for Open Text.

AB: The history of Open Text is that it started out using search-engine technology from the University of Waterloo, and rather than go toe-to-toe in the consumer market with competitors like Alta Vista, it focused on helping companies navigate their unstructured data – e-mails, memos, reports – in a similar way to how SAP helps companies deal with structured, database-type data. The company has since expanded around that through acquisition and now talks about itself as a provider of "enterprise information management" software solutions, which includes things like content management, business-process management, customer-experience management, and information capture and discovery. It's one of the biggest software companies headquartered in Canada.

We've become quite comfortable with the CEO, Mark Barrenechea, who took over at the beginning of 2012 after holding senior positions at Silicon Graphics, CA and Oracle. At first we were concerned by his penchant for buzzwords and that he might pursue acquisitions predicated on revenue synergies. But he's done a good job of broadening what the company does through intelligent acquisitions that have been far less about revenue synergies and far more about buying undermanaged companies, cutting costs by plugging them

INVESTMENT SNAPSHOT

Open Text
(Nasdaq: OTEX)

Business: Global provider of software systems focused on finding, utilizing and sharing unstructured information across all devices employed within customers' organizations.

Share Information
(@9/29/15):

Price	**44.13**
52-Week Range	36.65 – 61.74
Dividend Yield	1.7%
Market Cap	$5.40 billion

Financials (FY ending 6/15):

Revenue	$1.85 billion
Operating Margin	18.8%
Net Profit Margin	12.7%

Valuation Metrics
(@9/29/15):

	OTC:CN	S&P 500
P/E (TTM)	23.1	20.6
Forward P/E (Est.)	12.0	16.4

OTEX PRICE HISTORY

THE BOTTOM LINE

Action in the company's shares over time provides a classic example of stock prices swinging far more wildly than underlying intrinsic business value, says Andrew Brenton. The pendulum today is swinging in favor of the patient shareholder, he says, as his $75-per-share estimate of intrinsic value is 70% above the current market price.

Sources: Company reports, other publicly available information

into an established infrastructure, and just running them better.

This is another case where we believe the growth opportunity through acquisitions is still very high. The company has been saying it can spend all of its free cash flow on accretive acquisitions, which we originally didn't believe but now do because of the broadening of the product line. We think the bottom line can grow over at least the next few years at a mid-teens rate.

How is the company navigating the cloud?

AB: Management expects the movement to the cloud to be a net positive in terms of the lifetime value of a customer. We're modeling it as neutral, but are starting to come around to the view that it will be better than that.

The stock, which trades in the U.S. as well as Canada, has been quite volatile this year, falling from a high of $61 in February to a low of $37 in July, recovering somewhat to a recent $44. What's behind all that?

AB: The good news is that he's healthy, but Mark Barrenechea had been on a partial leave to be treated for leukemia and when he got back he didn't like what he was seeing in terms of sales, so the company announced that it was unlikely to meet the Street's revenue and earnings expectations for the quarter ending in June. He also fired the head of sales and reorganized the sales organization. The market obviously didn't like that, but there was nothing in the news that caused us to materially change our cash-flow assumptions, so we ended up increasing our stake significantly.

Oddly enough, when the actual June-quarter performance was released in early August, the numbers were bang on the original expectations before the CEO suggested otherwise. The stock moved up some on the news and we sold most of the shares we had bought just a couple months earlier. Through it all our intrinsic value estimate has been consistently around $75, so we still consider the shares quite attractively priced.

Is Fairfax Financial [FFH:TO] a different kind of holding for you?

AB: A number of people have said that, but we go through the same process with it that we do with every other company. It's not a simple company, but there are some fundamental simplifying questions to answer. Do you think the investment team is going to continue to outperform the broad market and its competitors, and if so, by how much? Do you think there is as big an opportunity in India for them as [CEO] Prem Watsa believes? It's like everything else, we try to distill it down to the free cash flow that's going to come back to us and we believe that's not being well appreciated by the market.

ON FAIRFAX FINANCIAL:

Like everything else, we distill it down to the cash flow that will come back to us. That's not being well appreciated.

Describe a mistake you've made that has had an enduring lesson.

AB: One of my earlier mistakes was investing in a company primarily because I loved the industry, which was specialty pharmaceuticals. The company operated in the mature end of the industry, licensing existing products from big pharma and focusing on them in an effort to boost sales and cash flows. The lesson there was that while the industry matters, first and foremost it has to be about finding a company that outcompetes and outthinks its competitors and does the right thing. This company did none of that. We've had much better experiences with other specialty pharma companies since, but we've made sure to be completely aligned with their thinking and how they operated first.

Our problems are typically the result of our forecasts just turning out to be wrong. For example, we own a position in Evertz Technologies [ET:CN], a leader in selling high-quality broadcast equipment. It's always had technologically superior products, but has been in a multi-year process of trying to sell more of a complete solution to its customers. That's turned out to be more difficult to execute on the sales side than they thought and the results over the past couple of years have been below expectations. It may eventually turn out as well as we originally thought, but in the past year we've reduced our cash-flow estimates, resulting in about a 30% reduction in estimated intrinsic value. Over that time the share price hasn't changed much, but we've cut our position roughly in half, to less than a 3% weight, as the expected return has fallen relative to other holdings.

Does the recent market volatility make you nervous at all?

AB: We're really pretty good about not letting ourselves get overly positive or negative about the market in general. We spoke about Fairfax – listening to Prem Watsa speak, you might come away thinking you should sell all your public equities! We don't totally ignore market levels, but if you look at our portfolio today, the long-term expected returns from the cash flows of the companies averages in the mid-teens annually. When you see that, it's hard to make the argument we should be sitting in cash waiting for a pullback.

Part of thinking probabilistically for us is that there is a distribution of possible intrinsic-value outcomes for every company we own. Only one will occur, of course, but the less you pay for a stock, the fewer the outcomes on the distribution curve that are negative and the more that are positive. It's the classic value-investing mentality: the cheaper the investment, the lower the risk and the higher the expected return. We have a portfolio of stocks in which we believe the odds are still very much in our favor. We'll focus on that over how the wind is blowing at any given time in the market. VII