# Cardinal Capital Management, L.L.C.

## Small Cap Value

## Fourth Quarter 2017


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**FIRM OVERVIEW**

- Experienced, Stable Team
- 25-Year+ Track Record
- Repeatable Research-Driven Process
- FCF-Based Valuations
- Consensus Decisions
- Aligned Interests with Clients
- $3.1 Billion AUM

**OBJECTIVES**

- High-Quality Investment Results
- Preservation of Capital

## Market Commentary

Small and large cap indices, as represented by the Russell 2000 and 1000, rose 3.3% and 6.6%, respectively in the fourth quarter, and returned 14.7% and 21.7% for the full year 2017. The value and the growth indices within the Russell 2000 increased 2.1% and 4.6%, respectively, for the quarter and 7.8% and 22.2% for the year. For the quarter, the value index rose less than its growth counterpart due to a significantly larger weighting in poorly performing Financial Services stocks, a smaller weighting in the better performing Industrials sector, and a higher weighting in the poorly performing Real Estate and Utilities sectors. For the year, the value index rose less than the growth index because of larger weightings in the poorly performing Financial Services, Real Estate, and Energy sectors, as well as a lower weighting in the better performing Health Care sector. From an economic perspective, the performance of small cap stocks for the quarter is best viewed as cyclical with strength in the Consumer Discretionary, Energy, Industrials and Materials sectors while the Financials, Utilities and Technology sectors were weak. Nonetheless, stocks with higher market caps provided better returns while price to earnings ratios were a poor predictor of performance. Investor behavior was generally consistent with a more optimistic view of the economy, primarily in response to the passage of the Tax Cut and Jobs Act.

Third quarter GDP rose at a 3.2% annual rate, the first time since 2014 that the economy experienced two consecutive quarters of growth above 3%. During the fourth quarter, consumer sentiment continued to improve, reflecting a 16 year low in the unemployment rate and a pickup in industrial production following the hurricane-related dip. Inflation rose to 2.2% on higher energy prices, above the Federal Reserve's target on an annual basis. As expected, the Federal Reserve increased short-term interest rates at their December meeting and confirmed their plan to raise them three times in 2018. Nonetheless, ten year government bond yields ended the quarter only slightly higher at 2.4%. U.S. corporate profits rose 7.7% in the third quarter, in line with the solid second quarter growth rate. The U.S. dollar weakened over the quarter as prospects for economic growth in Europe and other large international economies improved. As a result of solid earnings prospects and a lower corporate tax rate, major equity indices closed near record highs. In the face of continued geopolitical turmoil, U.S. equity market volatility has remained remarkably low despite absolute valuations that remain high on a historical basis.


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### HOW CARDINAL SEEKS TO ADD VALUE

- Intensive fundamental research
- Detailed DCF-based valuation analysis
- Opportunistic stock selection balances risk and return
- Aim to identify good businesses whose stocks are temporarily out-of-favor in structurally inefficient market niches
- Annual return objective has always been 20%, making valuations more conservative
- Discipline similar to that used by companies and private equity investors, resulting in more than 70 investments being acquired since 1995

### INVESTMENT TEAM

**Eugene Fox, III**
*Managing Partner/Portfolio Manager*

**Robert Kirkpatrick, *CFA***
*Managing Partner/Portfolio Manager*

**Rachel Matthews**
*Partner/Portfolio Manager*

**Robert Fields**
*Partner/Portfolio Manager*

**Chitra Sundaram**
*Senior Research Analyst*

**Christopher Robertson**
*Senior Research Analyst*

**Michael Cotogno, CFA**
*Senior Research Analyst*

## Performance Commentary

The preliminary fourth quarter performance of Cardinal's Small Cap Value Composite, at 4.6% net of fees, outpaced the 2.1% return of the Russell 2000 Value Index. The main contributors to our relative performance were stock selection in the Consumer Staples, Information Technology, Real Estate, and Consumer Discretionary sectors and a higher weighting and stock selection in the Industrials sector. The main detractor was stock selection in Energy. In Consumer Staples, shares of MGP Ingredients rose sharply after the distiller of alcoholic beverages announced better than expected results and increased its inventory of aging whiskey, which it plans to sell in future years at much higher margins. In Information Technology, the stock price of Match Group increased as the online dating company raised guidance following the successful launch of Tinder Gold. In Real Estate, the share price of Howard Hughes rose as the company signed an attractive lease at its South Street Seaport commercial redevelopment and reported steady progress at its Summerlin and Ward Village residential projects. In Consumer Discretionary, the stock price of Nexstar Media increased sharply after reporting solid quarterly results and the lifting of restrictive FCC TV station ownership rules. In Industrials, the stock price of instrumentation and electronics provider Teledyne Technologies rose as a result of strong revenue and profit growth primarily from recently acquired companies, particularly e2V.

The preliminary full year performance of Cardinal's Small Cap Value Composite, at 13.6% net of fees, outpaced the 7.8% return of the Russell 2000 Value Index. The main contributor to relative performance was stock selection in the Information Technology, Industrials, Consumer Staples, Health Care and Telecommunications sectors. A lower weighting and stock selection in the Financial Services and Real Estate sectors also contributed. Detractors included stock selection in Energy and not owning Utilities. In Information Technology, our investment in internet-based services supplier IAC/Interactive was the largest contributor. It acquired publicly-traded Angie's List and merged it with its Home Advisor business in a transformational deal, and Match Group, its 83% owned subsidiary, produced results that beat expectations. In Industrials, the share price of nuclear components supplier BWX Technologies rose sharply as it raised its five year earnings expectations despite increased investment to support new growth opportunities. As highlighted previously for the fourth quarter, in Consumer Staples, MGP Ingredients was also a significant contributor to relative performance for the year. In Health Care, the stock price of Ligand Pharmaceuticals increased significantly as its royalties from drugs marketed by its partners' ramped and its pipeline of future products continues to develop. In Telecommunications, the share price of Wi-Fi provider Boingo Wireless rose sharply as its DAS (Distributed Antenna System) deployment remains robust and its cash flow turned positive with the completion of its service rollout at U.S. military bases. In Financials, the stock price of interdealer broker BGC Partners increased as it is expected to be a beneficiary of less financial services regulation, made the accretive acquisition of Berkeley Point, and subsequently took public its real estate brokerage business, Newmark Group. In Real Estate, the share price of Starwood Waypoint rose after it announced its merger with Invitation Homes, creating the largest single-family home rental company.

The annualized net return of Cardinal's Small Cap Value Composite since inception (July 1, 1992) is 12.9% versus 11.2% for the Russell 2000 Value Index. Cardinal managed approximately $3.1 billion in micro, small and SMID cap value assets as of December 31, 2017.

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## Highlighted Investments

Nexstar
MEDIA GROUP, INC.

At Cardinal, we focus on finding companies with solid fundamentals at opportunistic valuations. Nexstar Media Group owns or operates 170 full power television stations in 100 markets, reaching 39% of U.S. television households. Cardinal first purchased shares in the company in 2013 during an aggressive consolidation period of network affiliates sparked by better retransmission economics for larger players. We sold the stock three years ago because it reached our price target and due to concerns that the television networks would continue to take an increasingly larger share of the affiliates' high margin retransmission revenue. Since then, industry valuations have decreased while retransmission revenue as a percent of total industry revenue has grown. Nonetheless, the bargaining position of the affiliate groups relative to the broadcast networks has materially improved with their increased scale from a second wave of affiliate consolidation and from increased demand for network programming due to the emergence of several over the top programming providers. As a result, prospects for the continued growth of free cash flow by the network affiliates are strong. While we assign no value to FCC driven regulatory relief, it is likely that the recently relaxed duopoly rules will lead to further station swaps between affiliates. Duopoly markets have significantly higher operating margins; therefore such activity would permit the companies to optimize their portfolios. Our most immediate concern is that Nexstar carries a significant amount of debt from its recent acquisitions. Although this can provide enhanced equity returns, we are pleased to see management prudently beginning to pare its leverage. Based upon our forecast of a sustainable double digit free cash flow yield to Nexstar equity holders, we can achieve our high return objectives without relying on multiple expansion, which is unusual in this market.

Calavo

Calavo Foods is a global fresh food distributor and value-added product and services provider which operates through three divisions: Fresh Products, Foods, and RFG (Renaissance Food Group). The company's primary focus is the marketing and distribution of avocados and guacamole, as well as preparing and distributing fresh-cut, ready-to-eat fruits and vegetables, meal-kit ingredients and fully-prepared meals. Calavo employs advanced fruit ripening and food safety technologies in these businesses that produce superior freshness for the consumer. In the prepared snacks and meal business, Calavo has a national distribution network which allows it to deliver to more than 90% of the U.S. in less than 12 hours, three times faster than the competition. We first invested in Calavo in 2012 but sold it on valuation in 2015. After the CEO purchased $5 million of stock last June, we revisited the story. The avocado distribution business remains attractive as healthier eating continues to drive consumption along with an increasing Hispanic population which consumes four times more avocados and guacamole per capita than the average American. Volume growth at Calavo is key because they receive a per box fee which has been increasing as their mix shifts toward value added services such as already ripened fruit. With limited competition due to strong sourcing, Calavo's distribution business has pricing power and high returns on capital. The guacamole business also has significant growth opportunities under new leadership as evidenced by recent high profile wins at Starbucks and Walmart. With strong prospects in the nascent market for fully-prepared meal and meal-kit ingredients, RFG is perhaps the most interesting division. Through partnerships with grocery stores and on-line providers as well as with FreshRealm, a rapidly growing supply chain services provider to the perishable food industry, RFG has an enviable competitive position. Although Calavo appears expensive on near term metrics, given its visible growth potential and attractive margins, we believe the stock is very attractive primarily because it is not well followed with only one mainstream analyst covering the company.

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## Market and Portfolio Outlook

Our near-term outlook for equities remains cautious as equity market valuations are full despite most economic indicators pointing to steady growth for the year. As the Federal Reserve believes that inflation will reach its 2% target, they still expect to gradually raise interest rates during the year. Inflation could become an area of concern if global growth boosts commodity prices and tight labor markets accelerate wage increases. Despite economic fundamentals continuing to improve across much of the developed world, the U.S. dollar could gain support from improving U.S. growth, spurred on by a pro-business Trump agenda. The M&A market should continue to be active as long as inexpensive capital is available and high levels of shareholder activism continue to lead to corporate break-ups and sales of non-core assets.

Consistent with our investment discipline, our focus remains on the stocks of companies where business performance is generally less dependent on the growth rate of the U.S. economy. By attempting to limit macroeconomic risks and taking them only when we feel that we are being adequately compensated, we believe that we are reducing overall portfolio risk because tools under management's control are generally more dependable. Looking ahead, our portfolio companies continue to redeploy their free cash flow through share repurchases, dividends and opportunistic acquisitions which should bode well for future value creation.

## Disclosures

Net performance reflects the deduction of advisory fees and expenses which reduce an investor's total return on investment. Returns presume investment for the entire period indicated and reinvestment of all interest income, capital gains, dividends and other distributions. Performance returns are unverified estimates and have been computed by Cardinal. Depending on the timing of an investor's investment in the strategy, net performance for such investor may vary from the net performance stated herein. Past performance is not indicative of future results.

The Russell 2000 Index consists of the 2000 smallest stocks in the Russell 3000 Index that represent approximately 10% of the total market capitalization of that Index. The Russell 1000 Index consists of the 1000 largest stocks in the Russell 3000 Index that represent approximately 90% of the total market capitalization of that Index. The Russell 2000 Value Index measures the performance of the small-cap value segment of the U.S. equity universe and includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. These indices are included merely to show the general trend in the small-cap equity markets in the periods indicated and is not intended to imply that Cardinal's investments were comparable to the index either in comparison or element of risk. There is no guarantee that the performance of the strategy will meet or exceed any index. An investor cannot invest directly in an index.

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