

# Cardinal Capital Management, L.L.C.

## Small Cap Value

### Second Quarter 2018



#### FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- \$3.6 Billion AUM

#### INVESTMENT TEAM

**Eugene Fox, III**

*Managing Partner/Portfolio Manager*

**Robert Kirkpatrick, CFA**

*Managing Partner/Portfolio Manager*

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*Partner/Portfolio Manager*

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*Senior Research Analyst*

**Christopher Robertson**

*Senior Research Analyst*

**Michael Cotogno, CFA**

*Senior Research Analyst*

#### Market Commentary

Small and large cap indices, as represented by the Russell 2000 and 1000, rose 7.8% and 3.6%, respectively, in the second quarter. Within the Russell 2000, the value index rose 8.3% while the growth index rose 7.2%. The value index rose by more than its growth counterpart due to a higher weighting in better performing energy and real estate stocks. From an economic perspective, the relative performance of small cap stocks stemmed from the increased prospects of a trade war as small companies with their more domestic business mix are generally perceived to be less impacted by tariffs. Defensive sectors including health care, real estate and utilities performed better than most cyclical sectors such as materials, industrials and technology as investors feared that these pending trade actions would reduce global growth. Financial services stocks also lagged, particularly banks which benefit from a stronger economy and higher interest rates. There were strong fund flows into small cap stocks via ETFs, resulting in the smallest, less liquid stocks and lower quality businesses within the Russell 2000 index outperforming.

Although the current economic expansion has run for nearly nine years, recent leading indicators suggest solid growth over the near term with few signs of an impending recession. Under new leadership, the Federal Reserve has continued to methodically raise short-term interest rates despite modest signs of inflation as the impact of the tax cut has yet to be felt and there is little slack in the labor force. However, even with substantial new issuance, the U.S. yield curve is now near its flattest level in over a decade as long-term interest rates fell on worries that a trade war would reduce business activity and dampen inflation. The Trump Administration announced tariffs on steel and aluminum imported from the EU, Canada and Mexico and on \$50 billion of imported Chinese goods. Fulfilling a campaign promise, the President is attempting to open markets and eliminate tariffs put in place by our trading partners that have resulted in lost domestic jobs, persistent trade imbalances and an uneven playing field for American companies. Whether Trump's negotiating strategy proves successful is unclear. Regardless, his tactics have clouded the economic outlook, hurt business sentiment and increased equity market volatility.

#### Performance Commentary

The preliminary second quarter performance of Cardinal's Small Cap Value Composite, at 3.3% net of fees, lagged the 8.3% return of the Russell 2000 Value Index. The main detractors from our relative performance were stock selection in the energy, consumer staples, financials and consumer discretionary sectors along with a lower weighting and stock selection in the real estate sector. The primary contributors were stock selection in the industrials and technology sectors. In energy, Callon Petroleum's share price fell despite higher oil prices because of widening basis differentials in the Permian Basin caused by a short-term lack of adequate pipeline capacity and management's decision to finance the acquisition of adjacent acreage with equity. The stock price of consumer staples company HRG Group declined sharply after its 60% owned subsidiary, Spectrum Brands, reported weak results due to short-term manufacturing and distribution issues at two new facilities. Management has acted aggressively to fix these problems, but the market remains skeptical. In financials, the share price of interdealer broker BGC Partners was lower despite solid operating results on concerns about the company's ability to complete a timely tax-free spinoff of Newmark Group, its real estate services business. In consumer discretionary, the share price of Del Frisco's Restaurant Group declined after management announced the acquisition of Barteca Restaurant Group.

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## Performance Commentary

Although a good strategic fit with meaningful potential earnings accretion, the deal valuation was full and leaves the company highly levered. In real estate, our lower weighting detracted from performance as interest-sensitive REITs rallied when long-term rates fell. In addition, shares of property owner and developer Howard Hughes Corporation fell after the CEO sold stock to help finance the purchase of a long-term warrant on a much larger number of shares. In industrials, the stock price of CBIZ, a financial services and business consulting company, rallied on strong earnings and the potential benefits of tax reform on its business. The share price of CTS Corporation, a manufacturer of sensors and actuators in the technology sector, benefitted from strong organic growth in its non-automotive end markets and a lower tax rate.

The annualized net return of Cardinal's Small Cap Value Composite since inception (July 1, 1992) is 12.8% versus 11.2% for the Russell 2000 Value Index and 10.2% for the Russell 2000 Index. Cardinal managed \$3.6 billion in small and SMID cap value assets as of June 30, 2018.

## Market and Portfolio Outlook

Our near-term outlook for equities remains cautious as valuations are full, the economic cycle is extended, monetary policy is tightening and the possible imposition of tariffs could both slow the economy and accelerate inflation. Nonetheless, the U.S. economy is currently growing at a solid pace and the beneficial impact of the U.S. corporate tax cut is only beginning to be felt. The prospects for domestic small cap stocks appear better than for large caps as the stronger U.S. dollar is less of a headwind and the impact of tariffs is less consequential. However, if the trade issues are favorably resolved or if the U.S. economy starts to slow, small cap stocks would likely underperform. The Federal Reserve still expects to gradually raise interest rates and is unlikely to deviate from that path unless the trade situation escalates or inflation increases meaningfully. With heightened uncertainty, we continue to prefer stocks where the success of the investment is based upon company-specific prospects and less dependent on the general economic outlook. Our high return requirements and long-term focus often make risk averse environments challenging for our relative performance because investors shorten their time horizons.

The strong M&A market, increased corporate share repurchases from repatriated cash and the lower U.S. corporate tax rate are all supporting equity valuations. Private equity and activist hedge funds continue to unlock value by improving operational performance, divesting non-core assets and selling companies. These activities have been and will remain a source of alpha in our portfolio over time. We remain optimistic that our portfolio companies will continue to redeploy their free cash flow through share repurchases, dividends and opportunistic acquisitions which should bode well for future value creation.

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## Highlighted Investments



At Cardinal, we focus on finding companies with solid fundamentals at opportunistic valuations. Hostess Brands is a baker and distributor of iconic sweet baked goods such as Twinkies, Ding Dongs and Ho Hos. Prior to its most recent incarnation, Hostess experienced years of poor financial performance and in 2012 ceased operations. Private equity firm Apollo and food industry executive Dean Metropoulos acquired some of the assets and intellectual property of Hostess out of bankruptcy in 2013. The new management team who specialize in turnarounds, reformulated the company's products to extend shelf life and improve quality, consolidated operations, automated production, and shifted distribution to a warehouse model. After regaining most of their market share and achieving industry leading profitability, the equity owners chose to take the company public in 2016, although Metropoulos sold no stock. While the \$15 billion decadent foods category has experienced low single digit growth, Hostess has grown 8% organically over the last four years. This growth was the result of regained market share as well as successful new product innovation. After restructuring operations, management has focused on expanding its offerings by reintroducing its own iconic brands as well as by acquiring assets to add products in the breakfast pastry space. Investors are skeptical about the firm's ability to sustain attractive revenue growth, in part, due to the nutritional realities of the category. We expect Hostess to continue to take market share by launching new products in related niches and via acquisitions that will expand its market offerings. Our view is shaped by our previous successful investment in International Home Foods which was run by Metropoulos and subsequently sold to Conagra Brands. We anticipate that the equity market will positively revalue Hostess shares as management proves that it can execute its growth strategy or the company will be acquired by an industry buyer given the scarcity of growing high margin food businesses.



Orion Engineered Carbons is a Luxembourg-based global supplier of carbon black. Carbon black is the powder or pelletized form of carbon which is a byproduct of refining oil and burning coal. It is used to tint, colorize and enhance the performance of polymers, plastics, coatings, inks, textiles, adhesives, tires, and other goods. Globally, Orion has a 26% share of the \$1.7 billion market for specialty uses of carbon black and a 7% share of the \$9 billion market for carbon black used in tires. The relevant submarkets are regional in nature due to high transport costs and strict regulatory requirements. In the early 2000's, excess capacity led to a prolonged period of poor industry profitability. In recent years, new environmental regulations and aggressive enforcement of them in China led to plant closures and consolidation which has improved industrywide profitability. The fact that three major players control about 50% of the market, exhibit real financial discipline and possess attractive economics prompted Cardinal to examine the business. Assuming no global economic downturn, industry utilization rates should remain high into 2020 even with some capacity expansions. Beyond the structural improvements in the industry, Orion is focused on improving its business mix by developing new specialty applications at two to three times the cash operating margins as compared to carbon black used in tires. Despite better operating performance than its primary publicly-traded competitor, Orion has continued to trade at a discount to Cabot Corporation as Orion still reports in Euros. However, the company will transition to US GAAP financial reporting this year which should expand the pool of potential investors. With successful execution of its strategy, we believe that Orion's absolute and relative equity valuation should rise and better reflect the attractive economics of the business.

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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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