Cardinal Capital Management, L.L.C.

SMID Cap Value

First Quarter 2019

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

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Market Commentary

Small, SMID, and large cap stock indices, as represented by the Russell 2000, 2500, and 1000, rose 14.6%, 15.8%, and 14.0%, respectively, in the first quarter. Small cap stocks posted their best first quarter return since 1991 and highest for any quarter since 2011. The double-digit rebound in SMID cap returns follows the 18.5% decline in the fourth quarter. Within the Russell 2500, the value index rose 13.1% while the growth index rose 19.0%. The value index rose less than its growth counterpart due primarily to a higher weighting in the poorly performing financial services and utilities sectors and lower weightings in the better performing information technology and healthcare sectors. The sharp rebound in equity prices was likely due to a more favorable interest rate outlook from the Federal Reserve, optimism that the U.S. and China would settle their trade dispute, and the end of tax loss selling. However, lackluster economic data domestically and abroad caused the outlook for corporate earnings to fall and investors to rotate into less cyclical growth stocks. Loss-making companies in the Russell 2500 rose materially more than profitable ones, particularly in the biopharma and software and services industries, which created a challenging environment for relative performance for active managers. Fairly strong breadth accompanied the equity market rally, but institutional and individual investors have been net sellers while companies have been net buyers based on fund flow data.

U.S. economic growth in 2019 is forecast to be modest and almost certainly lower than in 2018 because of China-related tariffs, slower international growth, and less of a benefit from last year's corporate tax cut. Despite a weak February jobs report, U.S. unemployment is likely to remain low at 3.7% as employers are unable to find enough qualified workers for many jobs. Although near peak level, corporate earnings are expected to decline in the first quarter for the first time since 2016 due to weak international demand and higher wage, logistics, and raw material costs. The U.S. government shutdown and the trade dispute with China also slowed growth as companies adjusted and delayed business ventures. With economic growth slowing, the Federal Reserve's recent decision to forgo additional rate increases was welcomed by investors who believe this action will prolong the current U.S. economic expansion, notwithstanding a collapse of U.S.-China trade talks.

First Quarter Performance Commentary

The preliminary first quarter performance of Cardinal's SMID Cap Value Composite, at 11.3% net of fees, lagged the 13.1% return of the Russell 2500 Value Index. The main detractors from relative performance were stock selection in the industrials and information technology sectors and a drag from holding frictional cash in a rising market. In the industrials sector, the stock price of Resideo Technologies, a leading provider of residential thermostats and security systems, fell on lower 2019 financial guidance. Management stepped up the pace of new investments in order to improve its connected devices. With a dominant share in the installer channel, the company is trying to take share from early innovators such as Ecobee and Nest. The stock price of KAR Auction services also lagged in the quarter for reasons highlighted below. In the information technology sector, the share price of Itron, a provider of smart metering and data analytics to utilities and municipalities, fell on lower than expected 2019 guidance as the component shortage impacting its business will continue through the first half of the year. The primary contributors to relative performance were stock selection in the communication services sector and the lack of any holdings in the poorly performing utilities sector. In the communication services sector, the stock price of local television broadcaster Nexstar Media rose sharply on the substantial expected accretion from its pending Tribune Media acquisition, an improved outlook for core advertising, and expectations for strong TV spending in the 2020 election.

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The annualized net return of Cardinal's SMID Cap Value Composite since inception (May 1, 2010) is 10.9% versus 9.8% for the Russell 2500 Value Index and 11.3% for the Russell 2500 Index. Cardinal managed $3.6 billion in small and SMID cap value assets as of March 31, 2019.

Highlighted Investments

A couple of Cardinal's portfolio holdings, KAR Auction Services and Ligand Pharmaceuticals, lagged the sharp rebound in the first quarter primarily due to idiosyncratic events which caused their share price to disconnect from fundamental value. Normally, Cardinal would expect these positions to perform better in an environment in which investors rapidly shift their appetite for risk. Cardinal maintains conviction in these positions, which both remain as top five holdings as of the end of the quarter.

KAR AUCTION SERVICES

KAR Auction Services is a leader in online and physical wholesale vehicle redistribution in North America through its used car and salvage auto auctions. Cardinal owned the used car auction business through ADESA before its leveraged buyout in 2007 and have owned KAR since the company went public in 2009. The businesses operate in an oligopoly with attractive economics. KAR does not take title to the vehicles, but acts as an agent, earning auction fees from buyers and sellers and providing both with value-added services. The company has grown revenue and cash flow meaningfully since Cardinal purchased the stock, benefitting from higher used vehicle auction volumes, the growth in accidents due to distracted driving, and the increasing rates at which insurance companies declare damaged vehicles to be totaled. KAR has used its substantial free cash flow to reduce leverage, pay a dividend, repurchase stock, and to acquire businesses that profit from physical or online auction vehicles. Last year, in response to continued appreciation of salvage competitor Copart, KAR announced its intention to spin-off its salvage business. However, due to employee turnover at the IRS, approval of the tax-free spin-off was delayed. In addition, with strong results at ADESA and to capture a share in that emerging market adjacency, management accelerated its investment in TradeRev, a dealer-to-dealer online platform. Despite reporting in-line fourth quarter financial results and guidance, management handled the conference call poorly. This created uncertainty around the spin-off and investor concern about the growth prospects for ADESA given an expected flattening in the supply of volume to the used car auction industry. The call's messaging was intended to be positive but caused a sharp drop in the stock price. In early April, KAR received the IRS private letter ruling ensuring the tax-free nature of the spin-off and should obtain independent financing and proceed with separation by the end of June. Management has also enhanced its communication effort to clarify its message and educate investors about the future opportunities available in the physical and online portions of the used car auto auction business. With attractive opportunities to redeploy the growing free cash flow and its upcoming separation into two public companies, the valuation of KAR's stock should rebound further to better reflect the sound prospects and attractive economics of its underlying businesses.

Ligand

Ligand Pharmaceuticals develops and acquires early stage drug and drug discovery-related intellectual property and licenses it to larger pharmaceutical companies for development and commercialization. The partners are committed to developing the drugs while Ligand receives royalties and milestones if the drug candidates progress through the FDA approval process. As a result, partners bear most of the risk of failure rather than Ligand. Initially, the company focused on purchasing the rights to unique biological molecules. Ligand then acquired platform technologies that improve either drug research and development or the efficacy of compounds. In addition to a portfolio of approved drugs and technologies which generate over $120 million of revenue today, the company has over 200 potential future revenue opportunities. Cardinal has successfully invested in Ligand since 2013, but the stock price fell during the quarter as a result of two events. First, a short seller released a highly misleading report on the company which included information that was incorrect or misleading and failed to mention Ligand's most valuable asset, OmniAb. Second, Ligand announced that it was selling its largest cash flowing asset for $827 million. Although unexpected, the transaction was in-line with expectations of the asset's value. However, investors focused on the near-term earnings dilution. While accurate, the sale eliminated concerns about competition and patent expiration and de-risked the investment. Investors also overlooked the increasing value of Ligand's remaining assets and management's outstanding acquisition record. OmniAb stands out based upon management's cash flow analysis and comparable transactions because its current value of $2.0-$2.5 billion is more than today's proforma enterprise value of Ligand and compares to its

$187 million purchase price in 2016. With the recent decline in Ligand's share price, the portfolio managers have added to the investment because they believe Ligand's portfolio is worth over $2 billion, even without OmniAb. Corroborating this view, the company is repurchasing $200 million of its stock in the near-term, and the CEO has personally purchased stock.

Market & Portfolio Outlook

Cardinal's near-term outlook for equities is cautiously optimistic following the sharp rebound in the first quarter. Although corporate earnings guidance for 2019 has been underwhelming, monetary policy is no longer restrictive and a trade deal with China is expected to be signed which should reduce or eliminate the tariffs recently put in place by the two countries. The team does not expect a recession in 2019 and, barring a policy mistake, the U.S. economy should grow moderately. Equity valuations remain relatively attractive as long-term interest rates have fallen and are low by historical standards. Recession fears and slower earnings growth have depressed small cap stock prices relative to large caps, but with easier comparisons in the second half of 2019, earnings growth should turn positive and benefit small cap valuations.

In Cardinal's portfolio, three portfolio holdings have announced or are rumored in the media to be exploring strategic alternatives for some or all of their business. Extended Stay America owns and operates branded mid-priced extended stay hotels. In March, management announced that they are open to alternatives which may include the sale of the Extended Stay operating company after several similar transactions resulted in material value creation for investors. Genesee & Wyoming owns or leases 121 short line railroads in North America, Europe, and Australia and is rumored to be exploring strategic alternatives with parties including funds such as Brookfield Infrastructure Partners. It would make sense for management to evaluate options at this time because the company has not completed a significant acquisition in the last couple of years and could create significant value by combining with the other major owner of domestic short line railroads, privately-held Watco Companies. Interestingly, Watco recently entered into a $450 million-dollar strategic partnership with Oaktree Capital while another Brookfield affiliate announced last month that they were buying a controlling interest in Oaktree. Finally, Kaman, a mini-conglomerate with the majority of its value in its specialty aerospace and defense operations, is rumored to be exploring the sale of its industrial distribution business. Cardinal has encouraged this action for several years as the distribution operation is subscale and its sale would unlock the value of Kaman's attractive bearings business.

In addition to these definitive catalysts, the team is confident in the business and investment prospects across the portfolio. Cardinal continues to prefer stocks where company-specific prospects, which are in management's control as much as possible, determine investment success. The investment team remains optimistic that 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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The Russell 2500™ Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "SMID" cap. The Russell 2500 Index is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2500 Value Index measures the performance of small to mid-cap value segment of the U.S. equity universe and includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. 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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