

Cardinal Capital Management, L.L.C.

SMID Cap Value

Fourth Quarter 2019

FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- \$3.9 Billion AUM

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

Market Commentary

Small, SMID, and large cap stock indices, as represented by the Russell 2000, 2500, and 1000, rose 9.9%, 8.5%, and 9.0%, respectively, in the fourth quarter. Within the Russell 2500, the Value Index rose 7.1% while the Growth Index rose 10.6%. The Value Index rose less than its Growth counterpart due primarily to its much lower weighting in the better performing health care sector. Health care stocks rallied over 20% as the prospects for more radical health care reform, including "Medicare For All," declined as the popularity of more moderate Democrats grew, and President Trump's poll numbers improved. Equity returns were strong in the fourth quarter as recession fears abated due to better than expected economic data, the phase one trade agreement with China, and more accommodative monetary policy. As typically occurs when investors become more optimistic, the performance of smaller market capitalization stocks was the best. It is unusual, however, for growth stocks to keep pace with value stocks when investors believe that economic conditions are poised to improve. This suggests that optimism over the economic outlook remains muted despite increases in long-term interest rates and a steeper yield curve.

U.S. economic growth ticked up to 2.1% in the third quarter as strong consumer spending buoyed by historically low unemployment and rising wages offset the negative effect of the trade war with China. Although most economic indicators remained resilient, the Federal Reserve did cut short-term interest rates for the third time in 2019 and began to increase reserves through the purchase of treasuries. Among the reasons cited by the Federal Reserve for this "mid-course correction" in interest rates were U.S. trade policy, weak manufacturing data, tepid international growth, and falling business investment. Interestingly, investors largely ignored President Trump's impeachment because it appears clear that the Republican majority in the Senate will not vote to convict him. However, given the economic policy differences between Republicans and Democrats, the approaching election will likely increase equity market volatility after being mostly absent in 2019. Despite the good performance of equities, retail investors remained net buyers of bonds and sellers of stocks.

Fourth Quarter Performance Commentary

The preliminary fourth quarter performance of Cardinal's SMID Cap Value Composite, at 9.2% net of fees, outpaced the 7.1% return of the Russell 2500 Value Index. The primary contributors to Cardinal's relative performance were stock selection in the real estate and communication services sectors, a higher weighting and stock selection in the better performing information technology sector, and not owning poorly performing utilities. In the real estate sector, the share price of Gaming and Leisure Properties rose after the real estate investment trust extended the maturities of its debt and lowered its overall cost. Also, shares of Newmark Group rose after the commercial real estate broker reported better than expected results and was active in their share repurchase program. In the communication services sector, the stock price of Nexstar Media rose after management met with investors to discuss the TV broadcasting industry and the company's prospects post its acquisition of Tribune Media. In the information technology sector, the share price of Silicon Motion rose sharply after the largest merchant supplier of controllers used in cellphones and solid-state disc drives issued better than expected guidance.

The main detractors from relative performance were stock selection in the industrials and consumer discretionary sectors. In the industrials sector, the share price of wholesale car auction provider KAR Global declined after the company reported earnings that missed expectations due to margin pressures in its Adesa and TradeRev units, which caused the company to lower its full-year outlook. In the consumer discretionary sector, the share price of

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Six Flags declined on lower than expected results, which showed little organic growth as the theme park operator is shifting to a more recurring membership-based sales model. Concerns about international licensing growth also impacted the stock.

2019 Performance Commentary

The preliminary 2019 performance of Cardinal's SMID Cap Value Composite, at 28.4%, net of fees, exceeded the 23.6% return of the Russell 2500 Value Index. The main contributors to relative performance were stock selection in the real estate, communication services, industrials, information technology, energy, and consumer discretionary sectors. In the industrials sector, the stock price of Teledyne Technologies rose sharply as the electronics and instrumentation supplier raised its earnings forecast every quarter due to strong operational performance and accretive acquisitions. In the real estate sector, the previously mentioned Gaming and Leisure Properties was a strong contributor for the year as was Medical Properties Trust whose share price rose as the medical office REIT continued its steady pace of accretive acquisitions. In the communication services sector, the stock price of internet services provider IAC/InterActiveCorp rose on strong results at the company's publicly traded subsidiary, Match Group, which will separate from its parent company in the first half of 2020. In the information technology sector, the share price of Cypress Semiconductor rose sharply after the company announced it was to be acquired by Infineon. In the energy sector, shares of Permian-based Parsley Energy significantly outpaced peers as the company transitioned to positive free cash flow and initiated a dividend. In the consumer discretionary sector, the stock price of Lithia Motors climbed sharply as improved results from the underperforming automobile dealers that it had acquired produced better than expected earnings growth.

The main detractors from relative performance were the drag of holding residual cash in a rising stock market and stock selection in the consumer staples and health care sectors. In the consumer staples sector, the stock price of B&G Foods fell due to poor results stemming from logistics and commodity cost pressures, margin pressures from costs related to the sale of Pirate's Bounty, a recall, and delayed realization of cost savings that never fully materialized. Cardinal sold the position. In the health care sector, the share price of Ligand Pharmaceuticals fell following the sale of its largest royalty stream, which was dilutive to near-term earnings, and after the FDA made the regulatory pathway for its promising diabetes drug candidate uneconomic in the United States. Ligand has since reported better than expected financial results due to its OmniAb drug development platform and repurchased nearly 20% of its outstanding shares.

The annualized net return of Cardinal's SMID Cap Value Composite since inception (May 1, 2010) is 11.6% versus 10.0% for the Russell 2500 Value Index and 11.5% for the Russell 2500 Index. Cardinal managed \$3.9 billion in small and SMID cap value assets as of December 31, 2019.

Highlighted Investments



Silgan Holdings manufactures metal cans, closures, and plastic bottles primarily for leading consumer products companies such as Nestle, Campbell's Soup, and Del Monte Foods. Founded by two respected packaging industry veterans, the company acts as a processor and assumes little raw material price risk. As a result, Silgan provides its customers with attractive pricing under long term contracts while leaving itself with stable margins and substantial free cash flow. Through disciplined acquisitions and the astute use of financial leverage, Silgan amassed half of the North American metal food can market in the early 2000's and is the established low-cost supplier. Over the past ten years, management has applied the same strategy and deployed some of its free cash flow to enhance its plastic containers business and establish a third line of business in metal and plastic closures and dispensing systems. Silgan's management also used a portion of the free cash flow to repurchase shares, retiring nearly 30% of the outstanding equity. While Silgan's metal food can business remains very profitable, volume growth has been challenged over the last few years. Management remains focused on the growing pet food segment of the market, along with limiting exposure to the declining use of metal food cans for both fruits and soup. With increases in cash flow and the associated repayment of debt after a large 2017 dispensing systems acquisition, Cardinal believes Silgan is approaching its next value-creating opportunity for the deployment of capital. In addition, the potential exists for a strategic transaction at an attractive price should the founders look to exit their investment.

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Ashland Inc. is a global specialty chemical producer of active ingredients and performance additives for diverse consumer applications, including pharmaceuticals, nutrition, and consumer care. It also manufactures and sells performance additives for architectural paints and a variety of industrial applications. Ashland's origins were as an integrated conglomerate that spanned the chemical value chain from refining to specialized chemistries. The company engaged in a multi-decade rationalization process, which recently culminated with the spin of its automotive lubricant business Valvoline, and the sale of its composites division. What remains is an attractive chemical business. With an enviable roster of long-term consumer products customers, Ashland is well-positioned. In developed markets, Ashland's portfolio of innovative bio-functional ingredients serves the consumer's increasing demand for natural ingredients in products while maintaining performance. In emerging markets, the expansion of a brand-conscious middle class provides Ashland with new markets for its products while jump-starting the use of natural ingredients. Ashland recently appointed board member Guillermo Novo as its new CEO. He comes with a strong record of profitably growing similarly situated chemical companies through customer and market-focused research and development while controlling operating costs. Mr. Novo has already begun restructuring operations to create profit and cash flow accountability at the business unit level. Previous management had felt that Ashland was capable of growing sales in the low single digits with EBITDA growth in the high single digits. New management expects to lay out its strategic plan in the coming months, but preliminary comments suggest that these financial targets should exceed the old ones.

Market & Portfolio Outlook

Cardinal's near-term outlook for equities remains cautiously optimistic. Cautious due to the remaining trade uncertainties, mixed domestic economic data, and a volatile political situation. Optimistic because of resilient consumer spending, full employment, accommodative monetary policy, and low inflation. Although investors expect fourth quarter GDP to moderate, easier monetary policy and a de-escalation of the trade war could result in stronger growth in 2020. The consumer remains strong, and the manufacturing sector is poised to recover with a trade deal, which would let President Trump declare victory ahead of the 2020 election. However, the outcome of the U.S. election is a key risk that could accelerate the timing of the next recession. Also, recent escalating tensions in the Middle East introduce another risk to the equity market. With heightened uncertainty, Cardinal continues to prefer investments whose success is dependent primarily upon company-specific drivers rather than broader economic growth. The portfolio managers remain optimistic that Cardinal's portfolio companies will continue to redeploy their free cash flow opportunistically, 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 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. 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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