

Cardinal Capital Management, L.L.C.

Small 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

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Market Commentary

Small and large cap stock indices, as represented by the Russell 2000 and 1000, rose 9.9% and 9.0%, respectively, in the fourth quarter. Within the Russell 2000, the Value Index rose 8.5% while the Growth Index rose 11.4%. 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 Small Cap Value Composite, at 7.5% net of fees, lagged the 8.5% return of the Russell 2000 Value Index. The main detractors from relative performance were stock selection in the consumer discretionary, health care, and energy sectors and stock selection and a higher weighting in the consumer staples sector. In the consumer discretionary sector, the share price of 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. The stock price of Denny's declined on softer same-store sales despite significant progress made by the casual dining chain on its refranchising efforts. In the health care sector, the share price of Ligand Pharmaceuticals lagged despite reporting an in-line pretax profit forecast and solid pipeline development. However, a nonrecurring tax adjustment reduced Ligand's 2019 earnings guidance. In the consumer staples sector, the stock price of Calavo Growers, the largest distributor of avocados, trailed its peers despite reporting better than expected financial results and issuing in-line annual guidance. In the energy sector, the share price of Viper Energy trailed the sector return as the owner of mineral interests forecast lower than expected royalty growth due to fewer well completions on non-Diamondback Energy properties. Exploration and production operators have been cutting their capital spending to make progress towards cash flow neutrality.

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The primary contributors to Cardinal's relative performance were stock selection in the real estate, financials, and communication services sectors along with a higher weighting in the better performing information technology sector. Not owning poorly performing utilities also contributed. In the real estate sector, the share price 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 financials sector, the stock price of Columbia Banking System rose after the commercial bank posted strong loan growth while maintaining low deposit costs. 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. 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.

2019 Performance Commentary

The preliminary 2019 performance of Cardinal's Small Cap Value Composite, at 23.3%, net of fees, exceeded the 22.4% return of the Russell 2000 Value Index. The main contributors to relative performance were stock selection in the industrials, real estate, communication services, and consumer discretionary sectors, a higher weighting in the information technology sector, and a lower weighting in the energy sector. Not owning utilities also contributed. 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 share price of Community Healthcare Trust rose as the medical office REIT continued its steady pace of acquisitions to support its growing dividend. In the communication services sector, the stock price of Nexstar Media rose after the company completed its very accretive acquisition of Tribune Media, making Nexstar the largest local TV broadcaster. In the information technology sector, the share price of Lattice Semiconductor more than doubled as new management continued its turnaround of the well-positioned field-programmable semiconductor provider. 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 stock selection in the materials and health care sectors, and the drag of holding residual cash in a rising stock market. In the materials sector, the stock price of Orion Engineered Carbons fell sharply after the global supplier of carbon black issued a weak 2019 outlook as a result of lower demand from China. 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 Small Cap Value Composite since inception (July 1, 1992) is 12.1% versus 10.6% for the Russell 2000 Value Index and 9.7% for the Russell 2000 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

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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.



Community Healthcare Trust is a self-managed real estate investment trust which owns or provides financing almost exclusively for medical office buildings. Its management team has extensive experience in healthcare-related real estate as the CEO was previously the co-founder of Healthcare Realty Trust, today the second largest publicly traded healthcare office building REIT. Of note, executive management takes nearly all their compensation in stock, and the CEO has purchased shares in all primary equity offerings and the open market. His 3.6% ownership stake is now worth \$30 million. Management's business plan is to acquire \$25-\$35 million of mostly rural medical office buildings per quarter in off-market transactions for prices yielding investment spreads well over the industry average. Community Healthcare has also established partnerships with several developers of medical real estate buildings who take the risk before achieving a stabilized and leased up facility. These agreements provide a steady pipeline of properties for Community Healthcare Trust at more attractive yields than its property purchases. With respect to managing credit risk, management has a solid track record of successfully mitigating losses for properties whose operators run into trouble. In addition, the company also possesses good tenant and geographic diversification, well spread out lease expirations, and a solid track record of renewals. Cardinal was attracted to Community Healthcare because of its sub-scale status and low relative valuation, a setup similar to our successful investment in Physicians Realty Trust years earlier. Since the initial investment, Community Healthcare has executed its business plan, and its valuation has increased. Although its cost of debt has fallen, it is not yet investment grade. Despite the strong performance of the stock since Cardinal's first purchase, Community Healthcare remains underfollowed due to its sub-one-billion-dollar market capitalization. While its valuation on current results appears full relative to its peers, its growth rate is far superior. Although the quarterly pace of future acquisitions will likely remain choppy, the annual rate is smoother as most are pre-funded pursuant to the established developer relationships. In terms of catalysts, the CEO views Community Healthcare as his last business endeavor and intends to grow the business and then sell the company to a larger REIT once it gets to a more appropriate size. Thus, the investment team sees ample runway for growth in assets and cash flow.

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 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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