Cardinal Capital Management, L.L.C.

SMID Cap Value

First Quarter 2020

FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- $2.5 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, fell 30.6%, 29.7%, and 20.2%, respectively, in the first quarter. Within the Russell 2500, the Value Index fell 34.6% while the Growth Index fell 23.2%. The Value Index fell by more than the Growth Index because of a higher weighting in poorly performing financials and energy stocks and a lower weighting in better performing information technology and health care stocks. In response to the COVID-19 pandemic and governmental decisions to close much of the U.S. economy in March, the Russell 2500 suffered its worst quarterly decline, even greater than experienced during the Great Financial Crisis. The performance was consistent with fears of a recession as defensive sectors such as utilities, health care, and consumer staples performed significantly better than more cyclical sectors such as energy, materials, consumer discretionary, and financials. No debt and low financial leverage stocks, as well as lower beta and larger market cap stocks also outperformed. The valuation of the Russell 2500 fell to 13x trailing EPS, the lowest level since February 2009. Also, the relative valuation of small versus large capitalization stocks fell to its lowest level since November 1999. Although 2020 corporate earnings are going to drop significantly, they are not indicative of the normalized earnings power of businesses.

The unprecedented escalation of the COVID-19 virus, which has led to eighty thousand deaths worldwide in just a few months, defined the first quarter of 2020. With the world woefully unprepared for such a contagious and deadly virus, containment strategies have proven mostly inadequate due to a lack of tests and implementation delays in required broad-based social distancing. As a result, governments around the world closed non-essential businesses temporarily to avoid overwhelming their health care systems, effectively shutting down much of the global economy. In the U.S., governmental actions caused unemployment to rise by ten million people in two weeks and forecasts for second-quarter GDP to show a decline between 10% and 35%. To help individuals and businesses avert a significant recession, the U.S. government passed multi-trillion-dollar stimulus bills, and the Federal Reserve reduced interest rates to near zero and injected liquidity on a massive scale.

As absolute oriented value investors, Cardinal generally expects to outperform averages in declining markets. However, when financial markets cease to operate normally, as they did during the Great Financial Crisis, or when non-essential businesses are closed by government order as they are now, it is more challenging for Cardinal to add value over shorter periods. This is due in part to the high hurdle rate utilized in the firm's process that generally precludes Cardinal from owning the low-risk, low-return equities that investors flock to during periods of economic distress. Also, Cardinal's portfolio company management teams do not aggressively deploy capital when confronted with unprecedented economic conditions. Finally, most of Cardinal's portfolio companies employ prudent financial leverage to enhance returns on investment. Although normally viewed as positive, investors shy away from companies with debt when businesses are forcibly closed. These factors detracted from return during the first quarter but are also likely to contribute to future returns assuming businesses reopen later this year, and the economy demonstrates signs of recovery. It is important to reiterate that Cardinal invests with a five-year time horizon, and does not change this approach because the equity market fails to reward it for a short time. The good news is that periods of very strong returns almost always follow declines like these.

From Cardinal's perspective, a portfolio that performs well when most of the population is staying at home, or working remotely, should not work well in a regular economy. No doubt, there will be changes in people's behavior on the margin, but most should return to their normal activities when the pandemic ends. In this context, Cardinal's diversified portfolio of high-quality businesses is built to perform well under typical economic conditions. A pandemic is anything but normal and has impacted several portfolio companies. For example, some of the traditionally defensive healthcare holdings have seen their businesses temporarily affected because COVID-19 cases have delayed discretionary doctor and hospital visits. Also, the portfolio's aerospace and auto-related businesses have been impacted as the pandemic has reduced air travel and miles driven. While these businesses will resume regular activity once the pandemic recedes, some consumers may hold back from making major purchases, despite substantial government support.

Performance Commentary

The preliminary first-quarter return of Cardinal's SMID Cap Value strategy, at -36.3% net of fees, lagged the Russell 2500 Value Index return of -34.6%. The main detractors from relative performance were stock selection in the financials sector, not owning any better performing utilities, as well as stock selection in the health care and consumer discretionary sectors. In the financials sector, the share price of mortgage REIT Starwood Property Trust fell sharply in sympathy with peers on liquidity and leverage concerns in the commercial real estate sector. The stock price of California-based PacWest Bancorp also fell considerably despite having sold $2 billion of riskier loan types in the last two years. Investors are concerned about margin pressure resulting from the steep cut in rates by the Federal Reserve and about possible credit losses from the economic shock. In the health care sector, the share price of integrated biopharmaceutical solutions provider Syneos Health fell on concerns that clinical trials to which it provides development and analytics services would be delayed as a result of social distancing and the inability to recruit patients. In the consumer discretionary sector, the share price of theme park operator Six Flags declined on disappointing guidance and subsequent concerns that the company's parks would remain closed for an extended time due to COVID-19.

The primary contributors to Cardinal's relative performance were stock selection in the materials sector and holding residual cash in a sharply declining market. In the materials sector, the share price of consumer goods packaging manufacturer Silgan Holdings declined only modestly as demand for its customer's products rose considerably as consumers stocked up on food, beverages, and household supplies to comply with widespread shelter in place orders.

The annualized net return of Cardinal's SMID Cap Value Composite since inception (May 1, 2010) is 6.8% versus 5.1% for the Russell 2500 Value Index and 7.3% for the Russell 2500 Index. Cardinal managed $2.5 billion in small and SMID cap value assets as of March 31, 2020.

Portfolio Positioning

Despite the short-term challenges facing the vast majority of businesses in the current environment, the portfolio managers have made only modest changes to Cardinal’s portfolio holdings as the team believes that the stock market has overreacted to the fundamental developments across portfolio companies. Nonetheless, the investment team has used this significant market decline to identify other high-quality companies with good visibility whose share prices have fallen sharply to upgrade the portfolio. Due to the significant decline in equity prices few stocks have been unscathed. As a result, the opportunity set is large and thus the exercise is considerable and ongoing. Thus far, Cardinal has added two positions, Dolby Laboratories and BWX Technologies, a past holding described below.

Highlighted Investments

BWXT
BWX Technologies, Inc.

BWX Technologies is a leading U.S. government and commercial supplier of nuclear fuel, components, and services. It is organized into three divisions: Nuclear Operations, Nuclear Energy, and Nuclear Services. The crown jewel is the Nuclear Operations segment, which represents more than 80% of profits. This 60-year-old business provides critical maintenance, repair, and overhaul services to the U.S. Navy’s submarine and aircraft carrier fleet and is its sole source supplier of nuclear reactors, providing a stable multi-year backlog and attractive profitability. After a disappointing attempt to manufacture missile tubes and an extended timeline to enter the nuclear isotopes business, BWX’s profits are likely to be unchanged until 2021 when the Columbia class submarines enters production, a key reason Cardinal sold the position in 2018. Because of their monopoly position, BWX has historically traded at a 10-15% valuation premium to its defense industry peers. However, this premium disappeared in the first quarter when BWX shares declined 30% after the announcement of another delay in the medical isotope business and the potential removal of a Virginia class submarine from the 2021 Department of Defense budget request. Cardinal saw this reaction as an opportunity to repurchase BWX shares at an attractive valuation since the nuclear isotope opportunity was within sight, the high likelihood of the submarine being added back to the budget request, and their leading position to win other future business awards. Most importantly, BWX is well-positioned for attractive multi-year organic growth in revenue, earnings, and free cash flow. Nuclear Operations alone should provide 3% revenue growth and 10%+ growth in earnings assuming free cash flow is used for share repurchase and no increase in leverage over the next ten years. Given the Navy's public statements that they need at least 355 vessels to protect the country and that submarines, as well as aircraft carriers, are the backbone of the fleet, BWX's Nuclear Operations programs are very likely to retain broad funding support from Congress well into the future.

DOLBY

Dolby Laboratories was founded in 1965 with a focus on noise-reduction technology but has evolved into a leader in the development of audio and imaging technologies that enhance the consumer entertainment experience. Cardinal has long admired Dolby's business model with its high profit margins and significant barriers to entry. The company's brands, intellectual property, relationships with content creators, and large research and development budget make it almost impossible for others to effectively compete with Dolby's solutions. We revisited the company after management recently increased its share repurchase activity and concluded that Dolby was in the early stages of an adoption cycle that was likely to drive meaningful growth in its Atmos, Vision, and Dolby Cinema solutions. While the founding family retains voting control of the company, they have treated minority shareholders fairly over time and backed management's decision several years ago to increase research and development spending. The payoff from this investment should contribute meaningfully to the company's revenue and profits growth in the future. Although the stock has historically traded at a premium valuation, the recent market correction enabled us to buy an initial position at an attractive valuation. With over $1 billion of cash and no debt, Dolby has the liquidity to take advantage of the current market dislocation and solid prospects for revenue and earnings growth over the next decade.

Market & Portfolio Outlook

Cardinal's near-term outlook for the U.S. economy and equity market is cautious in light of the COVID-19 pandemic and the significant impact of closing non-essential businesses on the U.S. economy. Although the equity market has attempted to discount the economic impact expected over the next few quarters, a great deal of uncertainty remains. The U.S. has not experienced a virus that can spread so quickly and asymptomatically, nor is there historical precedent for a rapid and forced temporary shutdown of the economy and the hardship that it will cause. Fear has emerged as the dominant emotion, and the risk appetite of investors has dried up as unemployment rises, and investors sell assets to raise cash. This uncertainty will remain until there is a treatment or vaccine available, a national plan to protect those people most at risk, or when it is clear the rate of infections has hit an apex. Although the U.S. government and the Federal Reserve are committed to cushioning the impact of the pandemic and shutdown on the economy, fiscal and monetary policy has not been as comprehensive as desired.

Nonetheless, Cardinal is hopeful that thoughtful policy decisions, as well as progress on a vaccine and effective therapies, will improve investor confidence even before the U. S. economy rebounds. The longer the virus persists, however, the more likely the market will expect a gradual and extended economic recovery. For long-term investors, periods such as this have almost always proven to have created attractive opportunities to buy stocks. With heightened uncertainty, the portfolio managers continue to prefer investments whose success is dependent primarily upon company-specific drivers rather than broader economic growth.

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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