# Cardinal Capital Management, L.L.C.

## SMID Cap Value

## Third Quarter 2020

**FIRM OVERVIEW**

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- $3.0 Billion AUM

**INVESTMENT TEAM**

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*Managing Partner/Portfolio Manager*

**Robert Kirkpatrick, CFA**
*Managing Partner/Portfolio Manager*

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*Senior Research Analyst*

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*Senior Research Analyst*

## Market Commentary

Small, SMID, and large cap stock indices, as represented by the Russell 2000, 2500, and 1000, rose 4.9%, 5.9%, and 9.5%, respectively, in the third quarter. Within the Russell 2500, the Value Index rose 3.5% while the Growth Index rose 9.4%. The Value Index rose less than its growth counterpart primarily due to its much higher weighting in the poorly performing financials, real estate, and energy sectors. Like the second quarter, financials, and particularly bank stocks, were once again the Value Index's largest relative detractor. The stock market rose despite continued uncertainty related to the course of the pandemic and any further government fiscal stimulus. Fiscal and monetary actions to date have fueled a historic stock-market recovery that few predicted at the depths of the March downturn. Consumer discretionary was the best performing sector for the second consecutive quarter on expectations of a quick economic recovery. Despite investor optimism, cyclical small and mid-cap stocks as a group trailed the indices as they were dragged down by the performance of energy and financials sector stocks. The mixed market was also evident from a factor perspective as both larger market capitalization and the least profitable companies outperformed during the quarter. Notably, the difference between small and large capitalization stock returns on a 3-year rolling basis is the biggest since June 1999. Although 2020 corporate earnings estimates are moving higher, they are still depressed, so investors have increasingly focused on 2021 and 2022 numbers for valuation purposes.

Third quarter U.S. economic growth rebounded, following the 32% pandemic-related contraction in the previous quarter as businesses reopened, stay-at-home orders were lifted, and the federal government's unprecedented financial assistance flowed to struggling businesses and households. Unfortunately, this aid was not extended beyond August, leaving many businesses and consumers without ongoing assistance despite recent employment data showing over seven million more Americans out of work since February. Although the unemployment rate has declined in recent months, many furloughed or laid-off workers could become permanently unemployed should the pandemic continue. High unemployment and income disruptions will dampen consumer spending without additional government fiscal stimulus even though monetary policy should keep short-term interest rates near zero for a long time. In the near-term, the economy faces several risks, including the Presidential election's outcome, the inability of Congress to pass additional economic relief bills, and the lack of a national strategy to control the spread of the COVID-19 virus without the prompt availability of an effective vaccine. Although it is unlikely that there will be more forced business shutdowns, the pace of the U.S. economic recovery should inevitably slow.

## Performance Commentary

The preliminary third quarter return of Cardinal's SMID Cap Value Composite, at 1.2% net of fees, lagged the 3.5% return of the Russell 2500 Value Index. The main detractors from relative performance were stock selection and a higher weighting in the poorly performing information technology sector, stock selection in the health care and industrials sectors, and a lower weighting in the better performing consumer discretionary sector. In the information technology sector, the share price of Silicon Motion, the largest merchant supplier of flash controllers, fell on weaker than expected second half guidance due to an inventory correction in smartphones and slower non-hyperscaler datacenter spending in China. In the health care sector, the stock price of Ligand Pharmaceuticals declined despite reporting solid results and increasing its 2020 earnings guidance as investors feared that the development of other effective COVID-19 treatments or vaccines would hurt its Captisol sales next year. Ligand also announced the acquisition of Pfenex, which licenses its proprietary protein production technology to third parties in return for milestone payments and royalties. Well-suited for complex, large-scale protein production, Pfenex's customers' products have recently begun to be approved and marketed. In the industrials sector, the share price of rail car manufacturer and lessor Trinity Industries declined after the company reported disappointing results as the business performed slightly worse than the company's initial pandemic-recovery assumptions. Also, four of Trinity's frac sand customers declared bankruptcy, which forced the company to write down some of its assets. In the consumer discretionary sector, the portfolio's much lower weighting offset a significant rise in the share price of auto-dealer Lithia Motors.

The primary contributors to relative performance were stock selection in the real estate sector, a higher weighting in the better performing materials sector, and not owning utilities, which lagged the market. In the real estate sector, the share price of Gaming and Leisure Properties rose after the company reported better than expected results following the reopening of many of its properties. A real estate investment trust which owns casinos and leases them to operators, the company's tenants were able to raise debt and equity to fund operations, providing greater visibility to the REIT's future revenue and cash flow.

As explained last quarter, a global pandemic is highly unusual, so Cardinal's performance during this period was not likely to follow typical historical patterns. That was the case in the third quarter as 80% of the benchmark's gains were driven by six industries, which comprise less than 30% of the index. Not only are the six industries mostly cyclical, but they also had loss-making companies as the largest return contributors. This performance suggests that investors were positioning for a v-shaped economic recovery. Although the portfolio managers believe the strategy will benefit from an economic recovery, Cardinal's investments have always been more sensitive to capital deployment than the economy's direction. As a result, any broad-scale pause will remain a near-term headwind to relative performance. In that regard, Cardinal's portfolio companies only began to announce sizeable transactions during the quarter, with the benefits of these yet to be fully understood. However, if history is a guide, capital redeployment will add significant value for Cardinal's portfolio once confidence is re-established.

The annualized net return of Cardinal's SMID Cap Value Composite since inception (May 1, 2010) is 8.3% versus 7.1% for the Russell 2500 Value Index and 10.0% for the Russell 2500 Index. Cardinal managed $3.0 billion in small and SMID cap value assets as of September 30, 2020.

## Portfolio Positioning

Despite the modest return of the small cap value market during the quarter, there were wide divergences across sectors, industries, and stocks as investors tried to gauge the pace of recovery and the environment post-COVID-19. As a result, some positions that had erased most or all of the COVID-19 related declines and where expectations were too optimistic were reduced. The portfolio managers increased investments where the market price reflected caution despite Cardinal's assessment of sound long-term fundamentals. Overall, the portfolio managers made modest changes as the team believes that the market is overly focused on short-term fundamentals.

## Highlighted Investments

Verint Systems sells software and services to governments and corporations, including over 90% of the Fortune 500, enabling them to gather, process, analyze, and visualize actionable intelligence in customer engagement and cyber intelligence. In customer engagement, their products help organizations improve how they interact with their customers to lower costs and make them more effective. These technologies provide 24/7 customer service with prompt, detailed, and accurate information. In cyber intelligence, Verint solutions include security and intelligence data mining software used for predictive intelligence, complex investigations, security threat analysis, data, and asset protection, as well as for generating legal evidence and preventing criminal activity and terrorism. Initially focused on the call center market, Verint expanded into the security market in 1999. Verint completed its IPO in 2002 and bought out majority owner Comverse Technologies in 2013. Despite secular growth in its markets, Verint had disappointing results in 2016 and 2017 due to salesforce transition issues and weak cyber spending at a few Middle Eastern clients, which caused the company's stock price to decline sharply and Cardinal to take notice. Although Verint's results have improved significantly, the transition to a SaaS model has dampened growth but will improve visibility. Management's decision to spin-off its cyber intelligence business was the catalyst for Cardinal's purchase. There are few publicly-traded cyber intelligence stocks, and most are expensive because of the growth in cyber threats. Palantir's recent decision to publicly list its stock provides a relevant and attractive comparable for Verint's cyber spin-off. The remaining customer engagement business is well positioned as most large infrastructure vendors lack these capabilities, and there are few pure-play vendors of scale. With a private equity firm taking an 11%+ stake in the remaining customer engagement business, Verint plans to add capabilities over the next few years, but it eventually should be combined with a larger industry participant. Although the cyber intelligence spin-off will attract new investors, consistent organic growth is needed to warrant a higher valuation.

AXALTA

Axalta is a leading global manufacturer of high-performance coating systems focused on the automotive industry. With roots back to the horse-drawn carriage, the company sells coatings, color matching tools, application technologies, and training modules to a variety of customers. In 2013, DuPont sold Axalta to a private equity firm, which subsequently took it public in 2014. Cardinal has long admired Axalta's automotive refinish business, which represents about half of the company's EBITDA. This market-leading business is the crown-jewel of Axalta's portfolio because of its sticky customer relationships, high profit margins, and lack of cyclicality since it is tied to accident volumes. In 2019, management announced a strategic alternatives process, and Cardinal made an initial investment as we believed Axalta's value was higher than the market price despite concerns about cyclicality impacting the OEM automobile market. Given the high quality of the business, Cardinal was comfortable with Axalta's prospects as an independent company. The strategic review was concluded without a sale due to the pandemic, but Cardinal took advantage of the subsequent weakness in the shares to add to the position at attractive prices. In the near-term, Axalta's business is rebounding as driving patterns return to normal and new auto production ramps back up. The company also has rolled out cost efficiency programs and may pursue share repurchases or accretive bolt-on acquisitions to build shareholder value. Cardinal still believes that Axalta will be part of a larger organization at some point in the future to leverage purchasing power. Having been involved in at least three acquisition-related discussions in recent years, if Axalta is sold, Cardinal would expect its high-quality portfolio to be acquired at a premium valuation.

## Market & Portfolio Outlook

Cardinal's near-term outlook for the U.S. economy and equity market is cautious in light of the economic uncertainty related to the COVID-19 pandemic as well as the U.S. presidential election. As businesses have reopened and hopes for an effective vaccine have risen, investors' risk appetite has continued to increase even as unemployment remains very high. Also, the equity market rally has been concentrated in relatively few industries and stocks and is pricing in a new normal of economic activity that is increasingly internet-based. The potential for a second wave of the virus remains ever-present, especially as the Northern Hemisphere enters the fall season. The tremendous global effort to develop and deliver COVID-19 vaccines and treatments, if successful, would expedite a return to normal economic activity and a more positive long-term outlook.

The longer the virus persists, 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