Cardinal Capital Management, L.L.C.

Small 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

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Senior Research Analyst

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Market Commentary

Small and large cap stock indices, as represented by the Russell 2000 and 1000, rose 4.9% and 9.5%, respectively, in the third quarter. Within the Russell 2000, the Value Index rose 2.6% while the Growth Index rose 7.2%. The Value Index rose less than its growth counterpart primarily due to its much higher weighting in the poorly performing financials and real estate 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 Small Cap Value Composite, at 1.3% net of fees, lagged the 2.6% return of the Russell 2000 Value Index. The main detractors from relative performance were stock selection in the industrials sector, stock selection and a higher weighting in the poorly performing information technology sector, and a lower weighting in the better performing consumer discretionary sector. In the industrials sector, the stock price of CBIZ, Inc., an accounting and benefits advisory firm, lagged as its M&A pipeline was put on hold due to due diligence limitations associated with the pandemic. Although the company reported much better than expected second quarter results, it again withheld annual guidance as management has less visibility on project work in the second half. 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 consumer discretionary sector, the stock price of Oxford Industries, the owner of the Tommy Bahama and Lilly Pulitzer brands, declined despite reporting better than expected quarterly results because of weak second half guidance due to store closures and weak sales in certain destination-oriented markets impacted by COVID-19.

The primary contributors to relative performance were stock selection in the real estate and communication services sectors and not owning utilities, which lagged the market. In the real estate sector, the share price of medical office building focused REIT, Community Healthcare Trust, surged on better than expected results, solid rent collections, and FFO growth as management continued to raise additional equity at attractive prices. In the communication services sector, the stock price of the nation's largest independent local television broadcaster, Nexstar Media, rose on second quarter results that exceeded analyst forecasts and on the prospects for very strong advertising spend on the upcoming 2020 election cycle.

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. 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 Small Cap Value Composite since inception (July 1, 1992) is 10.7% versus 9.4% for the Russell 2000 Value Index and 9.1% for the Russell 2000 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

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 sales force 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.

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Esco Technologies was spun off from Emerson Electric in 1990 and has remade itself through bolt-on M&A into an industrial conglomerate focused on utility infrastructure, commercial and military transportation, renewable energy development, and the proliferation of wireless devices. Esco serves diverse markets with a sticky customer base and has good visibility on a large proportion of its products due to recurring revenue and long product cycles. Its operations are also solidly profitable and cash generative. Esco's crown jewel is Doble, which provides monitoring equipment, software, and services to utilities for diagnostic measurement essential to the electrical grid's on-going reliability. The company's aerospace and defense segment is also core and includes Vacco, Westland, and Globe, which provide highly engineered acoustic signature reduction solutions to the U.S. Navy, space, and industrial customers on a sole source basis. Cardinal uncovered Esco as part of its Itron due diligence a year ago and noted similarities to Teledyne, another industrial conglomerate investment that has been very successful. Most recently, Esco sold off its packaging division for an attractive valuation and paid off about half of its outstanding debt, freeing up capital for further deployment into the remaining businesses, which are better positioned and more profitable. Esco should also benefit from a narrower business focus and greater scale while the public market valuation could be further enhanced by increased sell-side coverage.

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

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