Cardinal Capital Management, L.L.C.

SMID Cap Value

Fourth Quarter 2020

FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- $4.2 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 31.4%, 27.4%, and 13.7%, respectively, in the fourth quarter, and rose 20.0%, 20.0%, and 21.0%, respectively, in 2020. Within the Russell 2500, the Value Index rose 28.5% while the Growth Index rose 25.9% for the fourth quarter. The Value Index rose more than its Growth counterpart due to its much higher weighting in the better performing financials and materials sectors. The Value Index rose 4.9% for the year while the Growth Index rose 40.5%, the biggest difference since 2000. The Growth Index outperformed the Value Index primarily because of its higher weighting in better performing health care and information technology stocks and lower weighting in the poorly performing financials sector. The stock market rose significantly in the fourth quarter as the hope for an effective COVID-19 vaccine became a reality. Investors reacted to the vaccine news and the passage of a second stimulus package by investing in a significant amount of small cap value ETFs, which caused the smallest market capitalization, lower ROE, and non-earning stocks to outperform. In addition, companies that had been hurt by economic lockdowns saw their stocks rebound sharply, while those that benefitted from people staying-at-home saw their stock prices lag. In summary, it was a volatile year for small and SMID cap stocks, which posted their best and worst quarterly returns ever.

The fourth quarter began with a lot of uncertainty about the coronavirus and the U.S. presidential election. However, investors looked beyond the continued spread of COVID-19 and focused on the unprecedented monetary and fiscal stimulus as well as positive news flow on vaccine development and distribution. Stock prices rose sharply after Phase III results from Pfizer and Moderna showed that their COVID-19 vaccines were highly effective and safe. Bond yields and oil prices also moved higher on expectations of increased economic growth once the vaccines are widely distributed. While the Trump campaign contested the election's results, President-elect Biden will take office later this month. Although Democrats will control the Presidency and both houses of Congress, the margin is narrow. Therefore, investors believe Congress will pass additional stimulus spending and that tax increases are unlikely until the economy improves. Despite the sharp economic rebound in the second half of 2020, GDP remains well below pre-pandemic levels.

Fourth Quarter Performance Commentary

The preliminary fourth-quarter return of Cardinal's SMID Cap Value Composite, at 27.5% net of fees, trailed the 28.5% return of the Russell 2500 Value Index. The main detractors from relative performance were stock selection in the better performing materials sector and holding residual cash in a sharply rising market. In the materials sector, the share price of consumer goods packaging company Silgan Holdings lagged the sector's nearly 33% increase as its business is largely insensitive to raw material prices and has benefitted from consumers staying-at-home. In addition, the share price of agricultural chemical supplier FMC Corporation trailed the materials sector as its business grew nicely despite pandemic related headwinds but is unlikely to benefit meaningfully from an acceleration in economic activity.

The primary contributors to Cardinal's relative performance were stock selection and a higher weighting in the better performing information technology sector, stock selection in the financials and real estate sectors, and not owning poorly performing utilities. In financials, Cardinal had strong performance in the diversified financials subsector and the stock prices of the banks in the portfolio increased over 50% due to a more optimistic credit outlook and depressed valuations. In the information technology sector, the share price of digital payment software provider ACI Worldwide rose sharply after activist investor Starboard Value purchased 9% of the company and encouraged the board of directors to pursue a sale. In the real estate sector, the stock prices of commercial real estate broker Newmark Group and real estate developer Howard Hughes Corporation both bounced back sharply on solid results after lagging for much of the year.

2020 Performance Commentary

The preliminary 2020 return of Cardinal's SMID Cap Value Composite, at 1.8% net of fees, trailed the 4.9% return of the Russell 2500 Value Index. The main detractors from relative performance were stock selection in the health care and industrials sectors, a lower weighting in the better performing consumer discretionary sector, and stock selection in the consumer staples sector. In the health care sector, the stock price of Ligand Pharmaceuticals lagged as the company made its largest acquisition, yet provided only modest accretion forecasts relative to the substantial purchase price. Management also hosted a poorly received investor day in which they provided conservative three-year financial forecasts that were below estimates as they excluded several drug candidates with large royalty rates. In the industrials sector, the stock price of nuclear component supplier BWX Technologies rose nicely in absolute terms but trailed the very strong sector return. Cardinal purchased the position near the market bottom in March, and it did not rebound as sharply as other industrials because its long-term government contracts are much less economically sensitive. In the consumer staples sector, the stock price of sweet baked goods purveyor Hostess Brands lagged the sector despite reporting better than expected results. The overhang from stock sales by its former Chairman and CEO also depressed investor sentiment until he exited his position near the end of the year.

The primary contributors to relative performance from a sector perspective were stock selection in the real estate sector and the portfolio's higher weighting in the materials sector. In the real estate sector, the shares of hospital real estate owner Medical Properties Trust posted solid returns as the business performed well despite the pandemic, collecting virtually all rents owed them and raising attractively priced capital to make accretive acquisitions. Although the portfolio's lower weighting in the consumer discretionary detracted from Cardinal's relative return, auto dealer Lithia Motors was a notable overall contributor. The company's share price doubled as management successfully navigated COVID-related challenges by aggressively lowering costs and optimizing revenue to produce record profits. Management also outlined an ambitious five-year plan to grow revenue and earnings by launching an online service and accelerating its pace of acquisitions.

The annualized net return of Cardinal's SMID Cap Value Composite since inception (April 1,2010) is 10.7% versus 9.5% for the Russell 2500 Value Index and 12.2% for the Russell 2500 Index. Cardinal managed $4.2 billion in small and SMID cap value assets as of December 31, 2020.

Highlighted Investments

Spectrum Brands

Spectrum Brands is a leading home essentials company that operates four businesses: Global Pet Care, Home & Garden, Hardware & Home Improvement, and Home & Personal Care. The company has leading market shares in each segment and well-known brands such as Baldwin and Cutter. Cardinal owned the stock previously through Harbinger Group's liquidation but sold it about a year ago after the two largest shareholders with board seats began to exit their positions following an extended period of poor operating performance. The Chairman replaced the CEO and increased the focus on investing in new products. Since then, operating performance has improved materially despite tariff cost pressures, and the valuation, at 8x gross cash flow, remains well below peers who trade in the low teens. Financial leverage has also improved to about 3x EBITDA, even with the company repurchasing $600 million in stock over the last two years. Cardinal believes that Spectrum's valuation will increase because organic growth should improve as new products gain traction and the company regains lost shelf-space. In addition, management will continue to make bolt-on acquisitions such as Armitage, a high-margin companion animal treat provider which should be very accretive because Spectrum will distribute its products through their Global Pet Care operations. Finally, the company will likely divest its non-core and low-margin personal care business as its performance continues to rebound. Should Spectrum's valuation discount persist, Cardinal believes that the company's pet care and home and garden businesses would be attractive to private equity.

XPOLogistics

XPO Logistics is an asset-light global transportation and logistics provider consisting of a highly integrated network of people, technology, and physical assets. Its products and services help customers efficiently manage their supply chains. Founded by serial entrepreneur Brad Jacobs in 2011, XPO was built via acquisitions of less-than-truckload, brokerage, truckload, intermodal, logistics, last-mile, freight forwarding, expedited freight, and managed transportation businesses. The company has attractive economics despite some economic cyclicality because 70% of its revenues are asset-light with highly variable costs and modest maintenance capital requirements. It is also a beneficiary of the rapid growth in e-commerce, which has accelerated due to COVID-19. In March 2020, management decided to postpone their pursuit of strategic options due to pandemic-related business disruption. The resultant decline in XPO's share price gave Cardinal the opportunity to purchase a position at a discounted valuation. Cardinal liked management's plans for aggressive cost reduction and revenue enhancement over the next eighteen months, as well as their commitment to maximizing shareholder value. Although still open to asset sales, the company recently announced its intention to spin-off their global contract logistics business which should help to reduce the conglomerate discount. With the positive vaccine news driving interest in economically sensitive businesses, XPO's share price has begun to recover. Cardinal expects that the valuation gap will continue to close as fundamentals improve due in part to the internal cost and revenue initiatives. Cardinal also believes that the market will reward XPO's continued steps to focus the portfolio on its market-leading high-quality less-than-truckload, contract logistics, and last-mile logistics businesses.

Market & Portfolio Outlook

Cardinal's near-term outlook for equities remains cautiously optimistic. On the optimistic side, 2021 GDP growth is estimated to be above 4%, bringing U.S. economic output closer to pre-pandemic levels. Fiscal and monetary stimulus should also remain significant given Democratic control of Congress and the White House. Higher corporate and individual tax rates and other restrictive regulatory actions are also likely on hold as the new administration focuses on the pandemic and repairing damage to the U.S. economy. The mergers and acquisitions market should continue to recover, although increased antitrust scrutiny is almost certain. On the cautious side, equity indices are at all-time highs even though corporate earnings are unlikely to match 2019's level until at least 2022. Higher inflation expectations driven by the increased deficit spending of a Democratic controlled government are also likely to cause long-term interest rates to rise. Finally, the rising number of COVID-19 cases and the challenges of vaccinating the U.S. population will dampen U.S. economic growth until at least the second half of 2021. While there is always uncertainty in forecasting business results, long-term changes in consumer and business behavior associated with the pandemic have only made the exercise more challenging. As a result, Cardinal continues to prefer investments whose success is dependent on company specific drivers with as many as possible under management control rather than broader economic growth.

TELEPHONE:
203-863-8990

FOUR GREENWICH OFFICE PARK
GREENWICH, CT 06831

WEBSITE:
www.cardcap.com