Cardinal Capital Management, L.L.C.

SMID Cap Value

First Quarter 2021

FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- $5.1 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, rose 12.7%, 10.9%, and 5.9%, respectively, in the first quarter. Within the Russell 2500, the Value Index rose 16.8%, while the Growth Index rose 2.5%, its fourth-best relative performance ever. The Value Index rose more than its growth counterpart due mostly to its higher weighting in the financials and energy sectors and holding better performing information technology, health care, and consumer discretionary stocks. Quarterly performance was consistent with a more optimistic view of the economy with SMID cap returns led by the energy, consumer discretionary, financials, and industrials sectors. Health care and information technology stocks, which had produced strong performance last year, lagged as these longer duration assets were more sensitive to the increase in long-term bond yields. Investors reacted to positive vaccination progress and the passage of a third stimulus package by continuing to invest in small cap value products. Profitable small cap companies outperformed significantly in the quarter after underperforming every quarter in 2020.

With an improving economy and unprecedented monetary and fiscal stimulus, the stock market continued to produce strong returns in the quarter. Forecasts for 2021 GDP growth increased to over 5% due to the supplemental COVID relief package passed by Congress last December and an additional $1.9 trillion spending bill passed this year. Despite the obvious benefits of strong economic growth, concerns about product shortages and inflation arose as it will take time for global supply chains to respond to the sharp rebound in activity. As a result, long-term interest rates rose but remain very low by historical standards. Although the pandemic impacted a major portion of the population, the strong government response and societal choices allowed U.S. households to save over five trillion dollars in 2020, some of which is likely to be spent as people are vaccinated and the economy reopens. Home sales have recovered quickly and now exceed pre-pandemic levels, while pent-up demand for travel, leisure, and recreation activities is expected to fuel a sharp recovery in those businesses once they fully reopen. Nonetheless, it is too early to know the full extent of the structural damage that the pandemic has done to the U.S. economy as there are still over eight million fewer jobs than there were before the outbreak. It is clear that the administration is committed to increases in fiscal spending and higher corporate and personal taxes. The Federal Reserve has also pledged to maintain low short-term interest rates until employment has recovered, even in the face of temporarily higher inflation. The biggest potential threat is a resurgence of COVID-19, which depends upon the ability of current vaccines to protect the population from the new virus variants.

First Quarter Performance Commentary

The preliminary first-quarter return of Cardinal's SMID Cap Value Composite, at 15.4%, net of fees, lagged the 16.8% return of the Russell 2500 Value Index. The main detractors from relative performance were industry and stock selection in the industrials sector, stock selection in the materials and consumer staples sectors, a lower weighting in the better performing consumer discretionary and energy sectors, and holding residual cash in a sharply rising market. In the industrials sector, Cardinal's ownership of commercial services and aerospace and defense contractors with significant government exposure was not rewarded as the market preferred cyclical businesses more leveraged to an economic rebound. Nonetheless, the share price of KAR Auction Services, which provides auction and other services to the wholesale used car market, declined 20% after announcing disappointing fourth -quarter results and guidance. Sharply elevated used car prices and pandemic-related moratoriums on auto repossessions have reduced auction volumes. Although impactful near-term, Cardinal expects these supply constraints will prove transitory. Also, in the industrials sector, shares of aerospace and defense contractor Kaman declined after the company issued below-consensus 2021 guidance because it removed a high margin foreign military order from its forecast due to uncertainty over the timing of required U.S. government approval. In the materials sector, shares of agricultural chemical producer FMC declined after the company reported weaker than expected results for the first time since 2017 due to a drought in Brazil, COVID-related supply chain issues, and a customs issue. In the consumer discretionary sector, although portfolio holdings kept pace with sector returns, the weighting was lower. Of the two current holdings in the sector, the share price of Lithia Motors, one of the largest national auto dealers, continued to perform strongly as management remained ahead of their five-year plan to reach $50 billion in revenues and $50 per share of earnings via acquisitions and its recently launched online platform. In the consumer staples sector, shares of sweet baked goods producer Hostess Brands lagged due to lowered earnings per share estimates to account for a higher tax rate and more shares outstanding.

The main contributors to performance were stock selection in the health care, financials, and communications services sectors and not owning poorly performing utilities. In the health care sector, the stock price of Ligand Pharmaceuticals rose as the share prices of heavily shorted stocks benefited when market participants covered positions. Cardinal sold the position on valuation. In the financials sector, the stock price of commercial bank PacWest Bancorp rose significantly after its earnings beat expectations on a lower than expected loan loss provision and the company announced a niche lending acquisition. As a result, its large valuation discount started to dissipate. In the communication services sector, the share price of television broadcaster Nexstar Media Group rose after the company reported fourth-quarter results that beat expectations, provided above consensus cash flow guidance for the next two years, and announced a new $1 billion share repurchase plan.

The annualized net return of Cardinal's SMID Cap Value Composite since inception (May 1, 2010) is 12.3% versus 10.8% for the Russell 2500 Value Index and 13.0% for the Russell 2500 Index. Cardinal managed $5.1 billion in small and SMID cap value assets as of March 31, 2021.

Highlighted Investments

John Wiley & Sons is a leading publisher of scientific, technical, and medical research. Its online publishing platform offers subscription or pay-as-you-go access to over nine million articles from 1,675 journals, as well as 22,000 online books and hundreds of reference works, lab protocols, and databases. The company also publishes technical textbooks for higher education and provides professional books and training services to corporations. Wiley has recently expanded into the design and delivery of digital textbooks and courseware for the university classroom, as well as the management of online programs. Wiley’s strong competitive position is clear from its high cash operating margins, returns on capital, and discretionary free cash flow. This has been critical as Wiley has repositioned its business through investing in digital assets to mitigate the secular decline of print textbooks and the transition of published research from print journals to digital platforms. After years of revenue declines, an inflection point has been reached as the growth in Wiley’s digital businesses is now more than offsetting the decline in legacy print. Management now expects modest organic revenue growth and high single-digit EBITDA growth as software and services drive higher margins. In the research publishing business, where Wiley is the smallest of the top three players, it is poised to gain share, especially in the pay-as-you-go market, which is not a focus of its competitors. In digital courseware, the pandemic is likely to make digital courseware a permanent addition to the university educator’s toolkit. Finally, strong employment growth should increase the need for skills-based higher-education and professional-education programs underpinning demand for Wiley’s online services. Despite these positive trends, Wiley’s valuation remains attractive due to limited sell-side coverage, skepticism about the ongoing demand for digital courseware, and the lack of good public comparables for its non-journal businesses. These factors provided Cardinal with the opportunity to initiate a position at an attractive valuation. As Wiley continues to execute its digital transformation and grow revenues and profits, its valuation should rise closer to its journal peers to better reflect the high quality of its business.

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Euronet Worldwide is an industry leader in processing secure payment transactions and developing leading-edge payment technologies. The company was founded in the 1990s after the fall of the Berlin Wall created the opportunity to establish a third-party ATM business in Eastern Europe. Since then, founder and CEO Mike Brown has done an impressive job managing the company. In addition to growing the core ATM business, he's made opportunistic acquisitions in adjacent fields, including ePay in 2003 and Ria (money transfer) in 2007. Over the last nine years, management has grown EBITDA by 19% on average, most of which was organic. The pandemic presented Cardinal with an opportunity to invest in a high-quality company at a discounted valuation with a talented and motivated CEO. COVID-19 related travel restrictions hurt the near-term outlook for the company's ATM business which largely caters to international tourists, however, this issue is likely transitory. At the same time, tailwinds in Euronet's businesses should drive attractive future growth. The most important of these was Visa's decision to enable dynamic currency conversion at ATMs globally, which doubles the available market in the company's electronic funds transfer segment and improves its profitability. In addition, the trend towards ATM outsourcing, the growing use of prepaid cards outside the U.S. to purchase digital content, and the opportunity to exploit the high margin structures of legacy money transfer providers should each support solid growth in Euronet's businesses over the coming years. While the verticals that Euronet operates in come with notable risks, Cardinal believes that the management team is capable of dealing with those challenges. With an undemanding valuation and the prospects of double-digit revenue and free cash flow growth, Euronet shares should appreciate significantly as its businesses recover and growth rates normalize.

Market & Portfolio Outlook

Cardinal's near-term outlook for equities remains cautiously optimistic. On the positive side, 2021 GDP growth is estimated to be above 5%. With COVID-19 vaccinations proceeding rapidly and certain parts of the economy fully reopening, job growth has begun to accelerate. Fiscal and monetary stimulus should remain significant given Democratic control of Congress and the White House. The Federal Reserve has also committed to keep short-term interest rates low until the economy has recovered despite the risk of higher inflation. Corporate earnings are forecast to recover significantly in 2021, particularly for small companies. The mergers and acquisitions market has also begun to recover despite increased antitrust scrutiny. On the negative side, equity indices are at all-time highs, and valuations are near pre-pandemic levels despite higher long-term interest rates. Corporate and individual tax rates, including those on capital gains, are also more likely to rise as President Biden searches for ways to pay for his infrastructure bill. Such tax increases would not only reduce corporate earnings but also incentivize investors to realize gains ahead of the increase. Finally, inflation is likely to increase with stronger economic growth, which should inevitably result in further increases in long-term interest rates. Higher long-term interest rates are also negative for most companies earnings, and have historically had a depressing effect on valuations.

While there is always uncertainty in forecasting business results, long-term changes in consumer and business behavior associated with the pandemic have 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 solely relying on near-term economic growth to produce sustainable growth in free cash flow.

Disclosures