

# Cardinal Capital Management, L.L.C.

## Cardinal Small Cap Value Fund - CCMSX

### First Quarter 2019

#### FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- \$3.6 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 and large cap stock indices, as represented by the Russell 2000 and 1000, rose 14.58% and 14.00%, respectively, in the first quarter. Small cap stocks posted their best first quarter return since 1991 and highest for any quarter since 2011. The double-digit rebound in small cap returns follows the 20.20% decline in the fourth quarter. Within the Russell 2000, the value index rose 11.93% while the growth index rose 17.14%. The value index rose less than its growth counterpart due primarily to a higher weighting in the poorly performing financial services sector and lower weightings in the better performing information technology and healthcare sectors. The sharp rebound in equity prices was likely due to a more favorable interest rate outlook from the Federal Reserve, optimism that the U.S. and China would settle their trade dispute, and the end of tax loss selling. However, lackluster economic data domestically and abroad caused the outlook for corporate earnings to fall and investors to rotate into less cyclical growth stocks. Loss-making companies in the Russell 2000 rose materially more than profitable ones, particularly in the biopharma and software and services industries, which created a challenging environment for relative performance for active managers. Fairly strong breadth accompanied the equity market rally, but institutional and individual investors have been net sellers while companies have been net buyers based on fund flow data.

U.S. economic growth in 2019 is forecast to be modest and almost certainly lower than in 2018 because of China-related tariffs, slower international growth, and less of a benefit from last year's corporate tax cut. Despite a weak February jobs report, U.S. unemployment is likely to remain low at 3.7% as employers are unable to find enough qualified workers for many jobs. Although near peak level, corporate earnings are expected to decline in the first quarter for the first time since 2016 due to weak international demand and higher wage, logistics, and raw material costs. The U.S. government shutdown and the trade dispute with China also slowed growth as companies adjusted and delayed business ventures. With economic growth slowing, the Federal Reserve's recent decision to forgo additional rate increases was welcomed by investors who believe this action will allow the current long-running U.S. economic expansion to continue, notwithstanding a collapse of U.S.-China trade talks.

#### First Quarter Performance Commentary

The first quarter performance of the Cardinal Small Cap Value Fund, at 8.48%, lagged the Russell 2000 Value Index return of 11.93%. The main detractors from relative performance were stock selection in the materials and financial services sectors and a drag from holding frictional cash in a rising market. Idiosyncratic issues with two larger holdings, KAR Auction Services and Ligand Pharmaceuticals, also impacted performance and are discussed below in highlighted investments. In the materials sector, the stock price of Orion Engineered Carbons, a global supplier of carbon black, fell significantly due to a weaker than expected 2019 outlook. Despite double-digit profit growth in rubber black due to strong price increases, exposure to the weak Chinese market for specialty black was more significant than expected. In the financials sector, the share price of Columbia Banking System fell on concerns over the impact of elevated prepayments on loan growth and higher expenses as the company rolls out new digital products. Also, the stock price of FB Financial fell due to pressure on its net interest margin following the company's move to secure more funding using higher cost deposits. The primary contributors to relative performance were a higher weighting and stock selection in the information technology sector and stock selection in the communication services sector. In the information technology sector, the share price of Lattice Semiconductor, which designs

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and sells high performance integrated circuits, rose sharply following better than expected guidance as the highly regarded new management team executes on the turnaround begun last year. In the communication services sector, the stock price of local television broadcaster Nexstar Media rose sharply on the substantial expected accretion from its pending Tribune Media acquisition, an improved outlook for core advertising, and expectations for strong TV spending in the 2020 election.

A couple of Cardinal's portfolio holdings, KAR Auction Services and Ligand Pharmaceuticals, lagged the sharp rebound in the first quarter primarily due to idiosyncratic events which caused their share price to disconnect from fundamental value. Normally, Cardinal would expect these positions to perform better in an environment in which investors rapidly shift their appetite for risk. Cardinal maintains conviction in these positions, which both remain as top five holdings as of the end of the quarter.

KAR Auction Services is a leader in online and physical wholesale vehicle redistribution in North America through its used car and salvage auto auctions. Cardinal owned the used car auction business through ADESA before its leveraged buyout in 2007 and have owned KAR since the company went public in 2009. The businesses operate in an oligopoly with attractive economics. KAR does not take title to the vehicles, but acts as an agent, earning auction fees from buyers and sellers and providing both with value-added services. The company has grown revenue and cash flow meaningfully since Cardinal purchased the stock, benefitting from higher used vehicle auction volumes, the growth in accidents due to distracted driving, and the increasing rates at which insurance companies declare damaged vehicles to be totaled. KAR has used its substantial free cash flow to reduce leverage, pay a dividend, repurchase stock, and to acquire businesses that profit from physical or online auction vehicles. Last year, in response to continued appreciation of salvage competitor Copart, KAR announced its intention to spin-off its salvage business. However, due to employee turnover at the IRS, approval of the tax-free spin-off was delayed. In addition, with strong results at ADESA and to capture a share in that emerging market adjacency, management accelerated its investment in TradeRev, a dealer-to-dealer online platform. Despite reporting in-line fourth quarter financial results and guidance, management handled the conference call poorly. This created uncertainty around the spin-off and investor concern about the growth prospects for ADESA given an expected flattening in the supply of volume to the used car auction industry. The call's messaging was intended to be positive but caused a sharp drop in the stock price. In early April, KAR received the IRS private letter ruling ensuring the tax-free nature of the spin-off and should obtain independent financing and proceed with separation by the end of June. Management has also enhanced its communication effort to clarify its message and educate investors about the future opportunities available in the physical and online portions of the used car auto auction business. With attractive opportunities to redeploy the growing free cash flow and its upcoming separation into two public companies, the valuation of KAR's stock should rebound further to better reflect the sound prospects and attractive economics of its underlying businesses.

Ligand Pharmaceuticals develops and acquires early stage drug and drug discovery-related intellectual property and licenses it to larger pharmaceutical companies for development and commercialization. The partners are committed to developing the drugs while Ligand receives royalties and milestones if the drug candidates progress through the FDA approval process. As a result, partners bear most of the risk of failure rather than Ligand. Initially, the company focused on purchasing the rights to unique biological molecules. Ligand then acquired platform technologies that improve either drug research and development or the efficacy of compounds. In addition to a portfolio of approved drugs and technologies which generate over \$120 million of revenue today, the company has over 200 potential future revenue opportunities. Cardinal has successfully invested in Ligand since 2013, but the stock price fell during the quarter as a result of two events. First, a short seller released a highly misleading report on the company which included information that was incorrect or misleading and failed to mention Ligand's most valuable asset, OmniAb. Second, Ligand announced that it was selling its largest cash flowing asset for \$827 million. Although unexpected, the transaction was in-line with expectations of the asset's value. However, investors focused on the near-term earnings dilution. While accurate, the sale eliminated concerns about competition and patent expiration and de-risked the investment. Investors also overlooked the increasing value of Ligand's remaining assets and management's outstanding acquisition record. OmniAb stands out based upon management's cash flow analysis and comparable transactions because its current value of \$2.0-\$2.5 billion is more than today's proforma enterprise value of Ligand and compares to its \$187 million purchase price in 2016. With the recent decline in Ligand's share price, the portfolio managers have added to the investment because they believe Ligand's portfolio is worth over \$2 billion, even without OmniAb. Corroborating this view, the company is repurchasing \$200 million of its stock in the near-term, and the CEO has personally purchased stock.

The annualized net return of the Cardinal Small Cap Value Fund since inception (April 1, 2014) is 5.25% versus 5.35% for the Russell 2000 Value Index. Cardinal managed \$3.6 billion in small and SMID cap value assets as of March 31, 2019.

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### Market and Portfolio Outlook

Cardinal's near-term outlook for equities is cautiously optimistic following the sharp rebound in the first quarter. Although corporate earnings guidance for 2019 has been underwhelming, monetary policy is no longer restrictive and a trade deal with China is expected to be signed which should reduce or eliminate the tariffs recently put in place by the two countries. The team does not expect a recession in 2019 and, barring a policy mistake, the U.S. economy should grow moderately. Equity valuations remain relatively attractive as long-term interest rates have fallen and are low by historical standards. Recession fears and slower earnings growth have depressed small cap stock prices relative to large caps, but with easier comparisons in the second half of 2019, earnings growth should turn positive and benefit small cap valuations.

In Cardinal's portfolio, four portfolio holdings have announced or are rumored in the media to be exploring strategic alternatives for some or all of their business. Extended Stay America owns and operates branded mid-priced extended stay hotels. In March, management announced that they are open to alternatives which may include the sale of the Extended Stay operating company after several similar transactions resulted in material value creation for investors. Genesee & Wyoming owns or leases 121 short line railroads in North America, Europe, and Australia and is rumored to be exploring strategic alternatives with parties including funds such as Brookfield Infrastructure Partners. It would make sense for management to evaluate options at this time because the company has not completed a significant acquisition in the last couple of years and could create significant value by combining with the other major owner of domestic short line railroads, privately-held Watco Companies. Interestingly, Watco recently entered into a \$450 million-dollar strategic partnership with Oaktree Capital while another Brookfield affiliate announced last month that they were buying a controlling interest in Oaktree. Kaman, a mini-conglomerate with the majority of its value in its specialty aerospace and defense operations, is rumored to be exploring the sale of its industrial distribution business. Cardinal has encouraged this action for several years as the distribution operation is subscale and its sale would unlock the value of Kaman's attractive bearings business. Finally, Providence Service Corporation is the largest provider of transportation services to those who can't otherwise access non-emergency healthcare services. It also provides in-home health assessment services through its minority interest in Matrix Medical Network. Management is rumored to be pursuing a sale after failing to successfully diversify its business via acquisition.

In addition to these definitive catalysts, the team is confident in the business and investment prospects across the portfolio. Cardinal continues to prefer stocks where company-specific prospects, which are in management's control as much as possible, determine investment success. The investment team remains optimistic that portfolio companies will continue to redeploy their free cash flow through share repurchases, dividends, and opportunistic acquisitions which should bode well for future value creation.

### Net Performance as of March 31, 2019

	Cardinal Small Cap Value Fund %	Russell 2000 Value Index %
Annualized Inception to Date*	5.25	5.35
3-Year	7.33	10.86
1-Year	-7.51	0.17
1Q 2019	8.48	11.93

\*Inception Date: April 1, 2014

*Net Expense Ratio: 1.00%, Gross Expense Ratio: 1.08% - Fee waivers are contractual through May 31, 2020.*

*Past performance does not guarantee future results. The performance data quoted represents past performance and current returns may be lower or higher. The investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. For performance data current to the most recent month end, please call 1-844-CCM-SEIC (1-844-226-7342).*

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First Quarter 2019

### Disclosures

There are risks involved with investing, including possible loss of principal. There can be no assurance that the Portfolio will achieve its stated objectives. Equity funds are subject generally to market, market sector, market liquidity, issuer, and investment style risks, among other factors, to varying degrees, all of which are more fully described in the fund's full or summary prospectus. In addition to the normal risks associated with investing, investments in smaller companies typically exhibit higher volatility.

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 2000 Value Index measures the performance of the small-cap value segment of the U.S. equity universe and includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Index consists of the largest 1000 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.

The investments discussed herein are not a comprehensive list of securities or positions held by the Strategy. There is no assurance that any securities discussed herein will be or remain in the portfolio or, if sold, have not been or will not be repurchased. Portfolio weights of the securities mentioned as of 03/31/19 are listed below:

KAR Auction Services (KAR): 3.9%, Ligand Pharmaceuticals (LGND): 3.6%, Orion Engineered Carbons (OEC): 0.8%, Columbia Banking System (COLB): 3.1%, FB Financial (FBK): 1.8%, Lattice Semiconductor (LSCC): 0.8%, Nexstar Media Group (NXST): 1.1%, Extended Stay America (STAY): 2.1%, Genesee & Wyoming (GWR): 2.6%, Kaman (KAMN): 1.5%, Providence Service Corporation (PRSC): 0.6%

Holdings subject to change. Current and future holdings subject to risk.

Any projections, market outlooks or estimates in this newsletter are forward looking statements and are based upon certain assumptions. Other events which were not taken into account may occur and may significantly affect the returns or performance of the Strategy. Any projections, outlooks or assumptions should not be construed to be indicative of actual events which will occur.

The Cardinal Small Value Fund is distributed by SEI Investments Distribution Co. (SIDCO), 1 Freedom Valley Dr., Oaks, PA 19456. Funds are managed by Cardinal Capital Management, L.L.C. (the advisor). SIDCO is not affiliated with Cardinal Capital Management, L.L.C.

The investment advisor for the Cardinal Small Cap Value fund has contractually agreed to reduce its fees and/or reimburse expenses in order to keep Total Annual Fund Operating Expenses (excluding interest, taxes, brokerage commissions, Acquired Fund Fees and Expenses and extraordinary expenses) from exceeding 1.00% of the Fund's Institutional Class shares' average daily net assets until May 31, 2020. These reductions have lowered operation expenses and increased total return to shareholders.

**To determine if the Cardinal Small Cap Value Fund is an appropriate investment for you, carefully consider the fund's investment objectives, risk, and charges and expenses. This and other information can be found in the fund's full or summary prospectus which can be obtained by calling 1-844-CCM-SEIC or by visiting [www.cardcap.com](http://www.cardcap.com). Please read the prospectus carefully before investing. There are risks involved with investing, including possible loss of principal. In addition to the normal risks associated with investing, investments in smaller companies typically exhibit higher volatility.**