Q3 | 2020

SMID Cap

THE LONDON COMPANY

Market Observations & Portfolio Commentary

Quarterly Market Update

US stocks traded higher during the quarter driven by improving economic data, monetary and fiscal stimulus, and optimism around the eventual availability of vaccines and treatments to fight COVID-19. Stocks traded higher during July and August, but declined a bit in September. For the quarter, stocks posted gains across the market cap spectrum led by Large Caps. The Growth indexes continued their outperformance over the Value. Though Cyclical sectors outperformed Defensive in the Small Cap space, there was little difference among Large Caps. At the individual stock level, exposure to Growth, Volatility, Size, and Momentum factors had a positive impact on relative performance, while Value, Yield, and Quality had a negative impact.

Key Performance Takeaways for the Quarter

- The London Company Small-Mid Cap portfolio returned 4.8% gross (4.6% net) during the quarter vs. a 5.9% increase in the Russell 2500 Index. Stock selection and our minimal allocation to cash were headwinds to relative performance, partially offset by positive sector exposure.
- We are bottom-up stock pickers, but sector exposures influenced relative performance as follows:
  - *What Helped*: Overweight Cons. Discretionary (the best performing sector) and underweight Financials (a weaker performing sector)
  - *What Hurt*: Underweight Healthcare and Industrials (two better performing sectors)
- Despite generating strong absolute returns for the quarter, the SMID Cap strategy lagged the Russell 2500, but it performed in line with our 85-90% upside participation expectations.
- In our concentrated approach of building portfolios, stock selection can vary on a quarterly basis and is not deemed significant over the short term. Often times, having limited or no exposure to a sector can positively or negatively impact short term performance as much as what is owned. In the case of Q3, results for the Russell 2500 favored growth over value; in addition, outperformance was derived from highly leveraged, loss making companies with bottom quintile Returns on Invested Capital. These were headwinds to performance for our higher quality portfolio.

Top 3 Contributors to Relative Performance

- **Entegris (ENTG)** – Despite some industry headwinds earlier in the year, ENTG continues to gain share in its specialty chemical consumable business. These results have translated to higher returns throughout the year. Long-term growth drivers around advanced nodes, higher materials per wafer and higher purity requirements should add to further share gain.
- **Varian Medical Systems (VAR)** – During Q3, VAR announced that it has entered into a definitive agreement to be acquired by Siemens Healthineers at a significant premium. The deal is expected to close in the first half of 2021.
- **Churchill Downs (CHDN)** – 2020 has been an anomalous year for CHDN. The Kentucky Derby was held later than usual and without fans, and CHDN's casinos were temporarily shut down earlier in the year. However, the stock has performed well on strong performance from its online betting platform as well as industry-wide optimism around iGaming and sports betting.

Top 3 Detractors from Relative Performance

- **NewMarket (NEU) –** Despite a rebound in the economy, NEU declined during Q3 due to its nearly 100% exposure to the automotive industry and miles driven by motor vehicles. NEU's 2Q20 earnings were weaker than expected, as management highlighted that the global transportation market came to a near halt during the early 2020 which greatly affected the consumption of NEU's products.
- **Perrigo (PRGO)** – PRGO traded down following its 2Q20 earnings release; investors were likely disappointed that management only reaffirmed guidance rather than raising it. In addition, ProAir was recalled despite having finally obtained FDA approval earlier in the year.
- **GCP Applied Technologies (GCP)** – GCP declined roughly 20% during the quarter. A slow recovery in non-residential construction driven by the pandemic is negatively impacting sales. While recovery may be slower than initially anticipated, we are optimistic after the company replaced the majority of the board and the CEO.

Trades During the Quarter

- **Exited: Mohawk (MHK)** – Sale reflects continuous struggles in the flooring industry and concerns around management.
- **Increased: Perrigo (PRGO)** – Addition reflects PRGO's progress on its turnaround and higher operating margins.
- **Reduced: Old Dominion Freight Line (ODFL) & Copart (CPRT)** – At the time of the trims, these were two of the largest positions in the portfolio. Both stocks had significantly outperformed in recent years and the market cap of both exceeded $20B. We typically start selling s/mid holdings once they exceed $20B in market cap. We remain attracted to their fundamentals, but felt smaller positions were warranted.
- **Initiated: GCP Applied Technologies (GCP)** – GCP is a global construction materials company operating under two segments: Specialty Construction Chemicals (SCC) and Specialty Building Materials (SBM). Revenue is stable and GCP maintains #1 or #2 share in its markets. Operating margins are depressed today, but should revert to low double digits. The balance sheet is strong with a small amount of net debt. Separately, activist investor, Starboard Value recently led a successful campaign to replace most of the GCP board. This could lead to greater innovation, lower costs, higher margins, and a possible split of the business. We believe GCP trades at a discount to its intrinsic value and we hold it in other strategies.

Looking Ahead

We are encouraged by the improvement in the economic data, but risks remain. In the near term, the US economy faces the dual risks of a possible spike in the virus potentially leading to delayed openings or business closings, and reduced unemployment benefits possibly limiting consumer income and consumer spending. In that environment, combined with relatively high valuations for stocks (20x P/E and 16x EV/EBITDA), we expect significant share price volatility. Longer term, we remain optimistic about the prospects for the economy. While we believe the risks and rewards are somewhat balanced as they relate to stocks overall, we always remain cautious and focus on limiting downside in each holding. Fortunately, we are still finding high conviction investment ideas with quality attributes to populate the portfolios.

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Performance

As of September 30, 2020

Composite	QTD	YTD	Annualized One Year	Three Years	Five Years	Ten Years	Inception to Date
Gross	**4.8**	**-3.9**	**0.9**	**9.3**	**10.1**	**12.3**	**15.6**
Net	**4.6**	**-4.5**	**0.2**	**8.5**	**9.3**	**11.5**	**14.8**
Russell 2500	5.9	-5.8	2.2	4.5	9.0	10.8	14.4

Inception Date: 3/31/2009

Contact information

The London Company
of Virginia, LLC
1800 Bayberry Court, Suite 301
Richmond, VA 23226

T 804.709.1244
F 804.649.9447
info@TLCAdvisory.com
www.TLCAdvisory.com

Disclosure notes

The London Company's performances are size weighted and annualized based on calculations for the period ending September 30, 2020. The characteristics discussed herein relate to a representative account, and not every client's account will have these exact characteristics. As London manages its client portfolios according to each client's specific investment needs and circumstances, London cannot affirm that the characteristics of the account shown are similar to all accounts participating in the strategy. This is due in part to the timing of trades by the Adviser, market conditions, cash availability, and the timing of client deposits and withdrawals. Therefore, prospective clients should not assume that similar performance results to those shown would have been achieved for their accounts had they been invested in the strategy during the period. None of the information contained herein should be construed as an offer to buy or sell securities, or as investment recommendations. An investment in a London Company strategy is subject to risks, including the loss of principal.

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Composite Creation/ Inception Date: March 31, 2009

Composite Definition: The Small-Mid Cap strategy is an extension of our Small Cap strategy with weighted market capitalization higher than our Small Cap portfolio, and is within the market capitalization ranges of the major domestic small to mid cap indices. Accounts in this product composite are fully discretionary taxable and tax-exempt portfolios with a minimum of $100,000 in assets. The product is measured against the Russell 2500 Index and has a creation and inception date of March 31, 2009. There is no use of leverage, derivatives or short positions. All actual fee-paying discretionary portfolios are included in one or more composites that have been managed for a full calendar quarter with limited restrictions and similar objectives. Composite may include accounts under dual contract.

Benchmark Description: Primary: Russell 2500 Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. Russell 2500 is a subset of the Russell 3000 Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. Secondary: Russell 2500 Value Index measures the performance of the small to mid-cap segment of the U.S equity universe. It includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. Benchmark returns are not covered by the report of independent verifiers.

Performance and Fees: Gross of fee returns are calculated gross of management and custodian fees and net of transaction costs. Net of fee returns are calculated net of actual management fees and transaction costs and gross of custodian and other fees. Returns may be net of miscellaneous fund expenses. The gross figures do not reflect the deduction of investment advisory fees. For example, an account that earned 15% per year for 10 years would have an accumulated return of 305% before fees and 270% after fees, assuming a 1% fee. Returns are calculated and stated in US dollars. Returns are calculated gross of withholding taxes on foreign dividends and interest. Dividends are reinvested. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

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