Q1 | 2022

Small Cap

THE LONDON COMPANY

Market Observations & Portfolio Commentary

Quarterly Market Update

US equities traded lower during Q1 reflecting concerns about higher inflation, a shift toward tighter monetary policy, and the war in Ukraine. There are increasing signs of decelerating growth as high inflation is limiting purchasing power. The Federal Reserve increased the fed funds rate and plans to begin tapering its balance sheet; moreover, it is expected to be more aggressive with monetary policy, given elevated inflation and low unemployment. All of the major indexes traded lower, but Large Cap held up best. The Value indexes significantly outperformed the Growth. In general, cyclical sectors outperformed the more defensive. In terms of market factors that drove performance, Value, Yield, and Momentum had a positive impact on relative returns. Growth and Quality were mixed, and Volatility factors had a negative impact.

Key Performance Takeaways for the Quarter

- The London Company Small Cap portfolio declined -7.4% gross (-7.6% net) during the quarter vs. a -7.5% decrease in the Russell 2000 Index. Relative outperformance was driven by stock selection, partially offset by negative sector exposure.
- We are bottom-up stock pickers, but sector exposures influenced relative performance as follows:
  - *What Helped*: Underweight Health Care & Info. Technology (two weaker performing sectors)
  - *What Hurt*: Underweight Energy (best performing sector) & overweight Cons. Discretionary (a weaker performing sector)
- While the portfolio modestly outperformed the benchmark, downside capture wasn't as strong as we would typically expect. No exposure to the Energy sector and limited exposure to deep value holdings restricted outperformance. Our tilt toward Quality also didn't help despite the market trading lower. If the downturn extend beyond a quarter, we believe investors will focus more on higher quality factors like return on capital, consistency of cash flow, and balance sheet flexibility.

Top 3 Contributors to Relative Performance

- **Matson (MATX)** – MATX continues to benefit from improving economic trends, robust consumer demand, and elevated shipping rates. The expedited China service remains the primary driver of growth with new capacity additions and higher demand for e-commerce goods. MATX has capitalized its significant cash generation to transform its balance sheet, return capital to shareholders, and invest for future growth.
- **Dril-Quip (DRQ)** – DRQ outperformed during Q1 as the market has squarely tied it to volatile oil price fluctuations. That said, DRQ rallied after reporting mixed 4Q21 earnings but provided strong evidence that the turn in offshore spending is occurring.
- **White Mountains (WTM)** – WTM outperformed during Q1 consistent with relative strength in insurance stocks overall. We believe that WTM is currently undervalued, as it has signaled a willingness to sell their specialty underwriting business. Its sale could fetch a considerable premium to what they paid back in 2018, generating significant gains.

Top 3 Detractors from Relative Performance

- **Tempur-Sealy (TPX)** – TPX was very strong in 2021 (up 74%), but it was weak to start 2022 as recent results showed that demand for bedding products is slowing. However, we think there is a favorable long-term setup as TPX is investing heavily in its various growth initiatives and continues to buy back a significant amount of stock. Valuation remains compelling and our thesis is supported by robust free cash flow generation, strong brand equity, and solid management execution.
- **Moelis (MC)** – MC was weak during Q1 as investors questioned the longevity of the M&A cycle given the very strong year the industry had in 2021. Shares declined to start 2022, even after reporting solid 4Q21 results. We maintain a positive outlook for the industry based on relatively low interest rates, high cash balances, and strong cash flow by many acquisitive companies.
- **Cannae Holdings (CNNE)** – CNNE underperformed during Q1 as shares of its holding companies declined and its discount to fair value continued to widen. The investment theses for its holdings remain intact, and we saw some encouraging results during Q1 at its largest portfolio positions (Dun & Bradstreet and Alight). Management has proactively monetized investments to simplify the portfolio and improve liquidity. They have also stepped up the pace of buybacks and believe it's one of the best uses of capital given the market dislocation.

Trades During the Quarter

- **Reduced: Penske Automotive (PAG)** – Reduced due to market capitalization, which now exceeds $7B following 80% rally in 2021.
- **Initiated: Lancaster Colony (LANC)** – LANC is a manufacturer and distributer of specialty foods. The business is split between Retail and Foodservice. The majority of Foodservice sales are under private label products (i.e. Chick-fil-A sauces), and LANC serves 15/25 top national chains of quick service restaurants (QSR). Retail sales primarily leverage LANC's owned brands such as Marzetti dips and Simply Dressed salad dressings, in addition to license agreements with brands such as Olive Garden, Buffalo Wild Wings and Chick-fil-A. LANC's legacy retail brand portfolio holds #1 or #2 position in its categories, and few foodservice suppliers are capable of manufacturing at the scale needed to meet growing QSR demand. LANC has impressive organic growth, and plans to shift its revenue mix toward higher margin license. LANC is adding capacity for license products and the pipeline for similar deals appears vast. Other attractive characteristics include a skilled management team, Chairman is a founding family member, >20% insider ownership, no debt and recent insider buying.

Looking Ahead

We expect greater volatility driven by higher than normal inflation, a more aggressive shift in monetary policy, and the war in Ukraine. Despite the many risks to the near term outlook, we believe there are reasons for optimism as well. Economic data is generally positive with solid corporate earnings, rising GDP, as well as low unemployment and higher wages for consumers. Separately, as the effects of COVID continue to fade, we could experience faster than expected global supply chain improvements, which could lead to lower inflation. Monetary policy will likely remain in focus. The big question is can the Fed get inflation expectations under control without causing a recession. We recognize the difficulty in navigating a soft landing, so the odds of a recession over the next couple of years have increased. That is the message we take from the recent inversion of the yield curve. In terms of equities, we note that multiple compression is likely given rising interest rates and higher than normal inflation. Given the unique risk backdrop, equity returns may be more modest and volatile going forward.

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Performance

As of March 31, 2022

	QTD	One Year	Three Years	Five Years	Ten Years	Inception to Date
Small Cap (Gross)	-7.4	1.1	11.6	9.5	9.1	12.6
Small Cap (Net)	-7.6	0.3	10.8	8.7	8.3	12.1
Russell 2000	-7.5	-5.8	11.7	9.7	11.0	8.7

Inception date: 9/30/1999

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 March 31, 2022. 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: September 30, 1999

Composite Definition: The Small Cap strategy invests mainly in conservative, low-beta small cap equities with a focus on above-average downside protection. Primarily we seek profitable, financially stable small cap companies that consistently generate free cash flow, high returns on unleveraged operating capital, trade at significant discounts to their intrinsic values, and are run by shareholder-oriented management. Positions are usually within the market capitalization range of the major, domestic small 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 2000 Index and has a creation and inception date of September 30, 1999. 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 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. Secondary: Russell 2000 Value Index measures the performance of small-cap segment of the U.S. equity universe. It includes those Russell 2000 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 investments, calculating performance, and preparing GIPS Reports are available upon request.

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